

Microfinance in India:

Overestimating its outreach?

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Summary

Today microfinance has become a familiar term that many associate with financially sustainable poverty reduction. Others, on the other hand, argue that it make poor people's lives even more rigid by making them slaves of debt. Seeing that no country in the world has more clients associated with its microfinance sector than India, there is a need for examining the quality of the growth in the Indian microfinance movement. What lead me to focus on the quality of the sector's outreach is that the sector now counts more clients than there are poor households in the country. If providers of microfinance truly direct their services toward the poor the dependence on informal sources of credit could be expected to have declined, and the "Report of the Committee on Financial Inclusion" (2008) should not have documented that exclusion from formal financial services in general is large, and that the poorer the group, the greater is the exclusion. The aim of this thesis is to challenge the argued outreach by considering the quality of it.

The paper accounts for why microfinance in India is needed, how the microfinance approaches aim to reach the people that traditionally are excluded from formal financial services, and it explores strengths and weaknesses in banking poor through the microfinance approaches. The thesis will discuss the group lending approach, the relationship between the size of microloans and the impact it has on the lives of poor persons, the problems associated with low quality self help groups, and it takes a closer look at the competition that is going on between the providers of microfinance and the effects this competition might cause. The reason why I use the word 'might' is because even though my informants expressed to witness the effects documented in this thesis, their statements alone does not allow me to argue that the effects are universal trends applying to the sector as a whole. However, the concerns raised in this thesis are in my view worrisome developments (though to greater or lesser extent), and I believe that it needs to be raised awareness of them. The concerns raised by my informants also led me addressed the Andhra Pradesh Ordinance. The ordinance came be in order to regulate the microfinance institutions as some of them allegedly charge extortive interest rates and redeem loans through coercive methods which cause poor clients to commit suicides. This thesis suggests that the ordinance might be a blessing in disguise more than it is an actual blessing for the sector.

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List of abbreviations

AKMI	Association of Karnataka Microfinance Institutions
AP	Andhra Pradesh
BC	Banking Correspondent
BDO	Block Development Officer
BF	Banking Facilitator
BIMARU (states)	Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh
BPL	Below Poverty Line
CDO	Chief Development Officer
CGAP	Consultative Group to Assist the Poor
CMF	Centre for Micro Finance
GDP	Gross Domestic Product
GoI	Government of India
HARC	Himalayan Action Research Centre
InSET	Initiative for Social & Economic Transformation
JLG	Joint Liability Groups
MFI	Microfinance Institution
NABARD	National Bank for Agriculture and Rural Development
NABFINS	NABARD Financial Service Limited
NBFC	Non-Banking Financial Company
NGO	Non Governmental Organisations
NPR	National Population Register
NREGA	(Mahatma Gandhi) National Rural Employment Guarantee Act
NSSO	National Sample Survey Organisation
PACs	Primary Agricultural Credit societies
PPP	Purchasing Power Parity
RBI	Reserve Bank of India
RFAS	Rural Finance Access Survey
RRB	Regional Rural Banks
Rs.	Rupees
SBI	State Bank of India
SBLP	Self Help Group-Bank Linkage Programme

SEWA	Self Employed Women's Association
SFMC	Small industries development bank of India's Foundation for Micro Credit
SHG	Self Help Group
SIDBI	Small Industries Development Bank
UN	United Nations
UNDP	United Nation Development Programme

Microfinance in India:

Challenging the outreach by considering its quality

1.1 Introduction

Today microfinance has become a familiar term that many associate with financially sustainable poverty reduction. Some say that microfinance organisations are engineering a social revolution, others refer to the phenomenon as a social movement “which is likely to mark an important turning point in human history” (Fernando, 2006a, p. 2). The year 2005 was proclaimed the International Year of Micro-Credit by the UN, and the Nobel Peace Prize was in 2006 bestowed to Muhammad Yunus and the Grameen Bank “for their efforts to create economic and social development from below” (The Norwegian Nobel Committee, 2006 [online]). However, some scholars, amongst others Jude L. Fernando, insist that the field has remained “somewhat insulated from critical scholarly inquiry and the few existing critical analyses have not been politically popular within academic and policy circles” (Fernando, 2006a, p. 3).

The popularity of microfinance has not passed India by. After adjusting for overlaps the country hosts about 70 million clients of microfinance that are being reached through the two approaches; the Self Help Group-Bank Linkage Programme (SBLP) and the Microfinance Institutions (MFIs) (Srinivasan, 2009, p. 2).¹ The SBLP alone has become the largest in the world in terms of outreach (Kelkar, 2008, p. 24 [online]), and the two approaches together thus show extraordinary outreach. Seeing that no country in the world has more clients associated with its microfinance sector, there is a need for examining the quality of the growth in the Indian microfinance movement.

My hypothesis is that the argued outreach of microfinance is overestimated because the sector, or at least parts of it, is characterised by a ‘touch and go’ approach. By ‘outreach’ I mean not only in terms of mere numbers, I also aim to explore the quality of the financial inclusion that is being realised through microfinance.² My main aim in this thesis will be to

¹ Both these approaches will be properly introduced and addressed at length in chapter five named: ‘What shape has the microfinance movement in India taken, and how does it aim to correct for the market failures in the formal economy?’

² Financial inclusion is in this text defined as the process of ensuring access to timely and adequate financial services to all the needy sections of the country’s population at an affordable price. These sections are often

challenge the impressive outreach by examining the quality of it. By ‘touch and go’ I mean that a provider of microfinance aim at spreading its services to as many as it can, as fast as it can, in the most cost-efficient manner achievable. This is not a bad thing in itself. However, if the provider avoids going to the most remote, hard to reach, low population density areas (reaching out to the people that are the furthest away from already established formal financial access points), or the provider, after forming the most cooperative and interested low risk villagers into groups move on to new areas in which client acquisitions is easily obtainable, the quality of the outreach might be less than desirable. When an organisation/institution chose ‘touch and go’ growth instead of going more ‘in depth’ in the area in which it operates, microfinance cease to function as an effective tool through which all deserving financially excluded poor might experience economic development, and the microfinance movement will no longer live up to its full potential in terms of creating socio economic development. ‘In depth’ connotes that the provider will focus on all of the residents in an area, not ignoring the potential beneficiaries that might need more persuading before accepting a loan, or who fear the idea of formal finance and will miss out on the possible benefits, financial as well as non-financial, unless the provider takes the time to inform and coach them. In areas in which the ‘touch’ is easily obtained, it also tends to be more focused on. This might lead to situations in which competition among the practitioners becomes too harsh. This thesis therefore also aims to examine how the competition among practitioners affect the quality of the services they provide, at whom they direct their services, how many times each client can access a microloan, and how it affects the sustainability of the providers.

We will now move on to explore the outreach of the approaches, the SBLP and the MFIs. The discrepancy we will discover between the number of poor households in the country and the number of financially excluded rural Indians and the number of clients reportedly having access microfinance is what makes up the rationale for why the quality of the outreach should be examined. The chapter ends in an outline of the thesis, i.e. the way in which I have chosen to address the inconsistency.

1.2 The outreach of the sector

In the following paragraphs I will introduce quite a lot of numbers which I understand might easily become mixed up, that is not too important. What I want you to be left with after

weaker groups and low income groups as they are the ones who are most often denied access to formal financial services.

reading them though, is a sense of how many people that are expressed to be in need of microfinance (some form of understanding of the argued demand), relative to the reported outreach of the sector (the supply of microfinance).

In early 2001, the National Bank for Agriculture and Rural Development (NABARD) forecasted that about one million self-help groups (SHGs) would be taking loans from banks, with a total membership of about 17 million people by 2008 (Harper, 2002, p. 177). In 2002 Harper wrote: “If the NABARD and SFMC [Small industries development bank of India’s Foundation for Micro Credit] forecasts are fulfilled, and if the present growth in the numbers of poor people does not accelerate, over a quarter of poorer Indian households will, by 2009, have access to formal financial services” (2002, p. 177-178).³ Chankova et al. argues that: “[W]ith 75 million poor households potentially requiring financial services, the microfinance market in India is among the largest in the world. Estimates of household credit demand vary from a minimum of Rs. 2,000 to Rs. 6,000 in rural areas and Rs. 9,000 in urban settings. Given that 80 percent of poor households are located in rural areas, total credit demand ranges between Rs. 255 billion and Rs. 500 billion” (Chankova et.al, date is lacking but they refer to numbers from March 2003, p. 7).

Today, relying on numbers from *Microfinance India: State of the Sector Report 2009*,⁴ we see that NABARDs forecast has been fulfilled by and large. “The outstanding SHG loan accounts were 4.14 million, representing an estimated membership of 54 million. ... The MFIs reported a total client base of 22.6 million as at the end of March 2009” (Srinivasan, 2009, p. 2).⁵ This amount to that overall coverage of the sector (narrowly defined as outstanding accounts of members of SHGs and clients of MFIs) now has reached 76.6 million people.⁶ Because the outreach of clients reported by banks and MFIs might in some cases

³ Harper based this assumption on that about 40 per cent of the population, about 400 million people, or some 80 million households lives in poverty, and that it is unusual for more than one member of a household to be in an SHG.

⁴ The *Microfinance India: State of the Sector Report (2008, 2009 and 2010)* will merely be referred to as the *State of the Sector Report (2008, 2009, 2010)* throughout the thesis as that is the name it is known by, and because I attended a roundtable on the *State of the Sector Report 2010* during one of my fieldworks. N. Srinivasan, the author of all three reports, points out that the numbers should be seen as approximate indicators of trends, and be evaluated in a comparative sense rather than in an absolute sense in the *State of the Sector Report 2008* (Srinivasan, 2008, p. 2). I point this out as this is likely to be relevant for the succeeding reports as well; though it is not specified in the 2009 report (the report for 2010 has not yet been released).

⁵ ‘Outstanding debt’ is defined as that portion of a debt which remains unpaid (McCracken, 2005, [online]). In the same way is an ‘outstanding loan’ referring to a loan which has not yet been repaid and ‘outstanding loan balance’ to the portion of the principal that has not been repaid.

⁶ “The broadly defined microfinance sector, including small accounts of commercial banks, small and vulnerable borrowing members of Primary Agricultural Societies, SHG members and MFI customers, had more than 135 million clients by the end March 2008 ... The number of accounts is more than double the number of poor households at 61.4 million” (Srinivasan, 2009, p. 3).

overlap, some adjustments to the number are made by N. Srinivasan who argues that the net client base of the microfinance sector is likely to be about 70 million people (2009, p. 2).⁷ The *State of the Sector Report* 2009 further documents that the outstanding loans in the books of banks against SHG has reached Rs. 241.96 billion by March 2009, while the outstanding loans of MFIs were 117.34 billion in 2008-2009 (Srinivasan, 2009, p. 2). The total amount of outstanding loans thereby amounted to 358.30 billion in 2009.

According to RBI's Priority sector finance Guidelines, available at the RBI webpage, providing microfinance as a category of priority sector lending goes as follows:

(iv) Micro Credit: Provision of credit and other financial services and products of very small amounts not exceeding Rs. 50,000 per borrower to the poor, either directly or indirectly through a SHG/JLG mechanism or any intermediary (including NBFC/NGO/MFI), or to an NBFC/NGO engaged in provision of credit to the poor up to Rs. 50,000 per borrower will constitute micro credit. The poor for this purpose, shall include persons below the poverty line in the respective areas [sic] (Reserve Bank of India, 2007, [online]).

Now, here is where things get interesting. The 61st round of National Sample Survey Organisation's (NSSO) survey estimated that 27.5 per cent of India's population is poor (Srinivasan, 2008, p. 1).⁸ Because of the gap I have come across with reference to how many households actually living in poverty in India,⁹ I have chosen to make my own calculations using estimates based on the national poverty line from 2009 and keeping to the commonly used average of five members in a household. According to my calculations about 317 720

⁷ "While it is difficult to accurately determine the overlaps, the overall number of clients has been reduced by 10 per cent. This would be equivalent to nearly 33 per cent of clients reported by MFIs and 13 per cent of clients under SHG linkage" (Srinivasan, 2009:21).

⁸ The number is based on the aggregated national poverty line, which rather strongly differ from the number provided by the World Bank. According to the World Bank webpage 41.6 per cent of the population lived on less than \$1.25 per day (PPP) in 2005 (World Bank, 2010a, [online]). PPP stands for Purchasing Power Parity. To explain PPP I have chosen to refer to *Ray's Development Economics*, he writes: "Briefly, *international prices* are constructed for an enormous basket of goods and services by averaging the prices (expresses, say, in dollars) for each such good and service over all different countries. National income for a country is then estimated by valuing its outputs at *these* international prices. In this way, what is maintained, in some average sense, is *parity* in the *purchasing power* among different countries" (Ray, 1998, p. 15, (the author's emphasis)). As most of my data is collected from reports and literature produced by Indian agents, I will refer to numbers based on the national poverty line unless I specify otherwise. I will nevertheless ask you to mark the gap between the national- and the World Bank- poverty estimates, as the data I will provide in this thesis might very well represent an underestimation.

⁹ Harper reports some 80 million households to be poor (Harper, 2002:177); Basu and Srivastava's data results in the finding of 92 million poor households. They report that 460 million people were poor in 2003 based on the international poverty line of \$/day, and by dividing this number with 5 (the commonly used average of household members) we end up with 92 000 000 people (Basu and Srivastava, 2005, p. 12); While N. Srinivasan, the person who provides the most recent data in the *State of the Sector Report* 2009, merely reports 61.4 million households living in poverty in 2009. But he does not give a reference as to where or how he found the number (Srinivasan, 2009:3).

611 people in India are poor,¹⁰ and 317 720 611 people divided by 5 in each household equals to about 63.5 million poor households in the country ($317720611/5=63\ 544\ 122$). If we compare the number of poor households to the argued outreach of the two approaches, the MFIs and the SBLP (given that my calculations can be justified, and we, as Harper does, suppose that it is unusual for more than one member of each household to be in a SHG, that the argued outreach of the microfinance sector is correct and that the services are directed at the poor), the situation should be that all poor households in the country have access to formal financial services through the microfinance movement alone, and that the approaches additionally provide about 5-10 million non-poor with financial services. This claim does not agree with the NSSO (National Sample Survey Organisation) data that is presented in the “Report of the Committee on Financial Inclusion” (2008) available at NABARD’s webpage:

[D]espite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). Farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. Thus, apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion (C. Rangarajan, 2008, p. i, [online]).¹¹

Due to the mismatch between the argued outreach (and thereby financial inclusion) reported by providers of microfinance, and the relatively high levels of poverty and financial exclusion that is documented in rural areas, I will argue that there is a need for further examining the quality of the outreach of the microfinance sector.¹² What constitutes being financially included; is a person included if he has a bank account in his name? Does the group lending approach correct for the market failures in the formal economy which excluded poor people prior to microfinance? Has competition in the sector become too harsh and affects the quality of the financial inclusion? Is it the poor that are being reached through this tool for poverty

¹⁰ To calculate the number of poor Indians I have had to rely on approximate numbers. A National Population Register (NPR) is expected to be realised during the year 2011, the population census 2011 will be conducted in two phases- house listing operations and population enumeration, the latter is expected to take place in February-March 2011 (Indian Express, 2010, [online]). Until this is realised I decided to rely on the number reported by the World Bank which states that the population now counts 1 155 347 678 people (World Bank, 2010b, [online]).

To come to the conclusion that approximately 317 720 611 Indians are poor I made the following calculation: $1\ 155\ 347\ 678$ (the total population) $\times 0.275$ (percentage of poor) = 317 720 611 poor people in India. I wish to point out nonetheless, that it is not uncommon for an Indian rural household to count more than five members. This might affect the number of households negatively, i.e. the greater the number of estimated poor that are living within the same household, the lower the number of total households will be.

¹¹ The page numbers in this article begin on page 11, all pages prior to this is referred to by me as pages i-xi so that it will be easier to trace where I have extracted the information from.

¹² Throughout this thesis the focus will be on the financial inclusion of rural residents.

alleviation? These are questions that will be addressed in this thesis, and they will be answered as we conclude whether or not the outreach of the Indian microfinance sector is overestimated.

This thesis does not wish to argue that the microfinance movement in India has failed, by no means. There is much evidence suggesting that a lot of people have been able to improve their realities after engaging in microfinance, and I personally believe that microfinance has the property to lift peoples self esteem, to help some become financially independent entrepreneurs, to improve nutrition in a household, to raise decision making power among the oppressed and to help people break free of bonded labour through debt swap schemes, among other such positive outcomes.¹³ The examples of good organisations/institutions, policies and clients are many, but the aim of this thesis is to examine the mismatch between the argued outreach of the sector and the number of financially excluded rural poor in the country. As most of the trends that we will explore derive from unfortunate practices and/or attitudes among providers, recipients and policy makers, please keep in mind that my seemingly critical and some time even negative tone is not representative for my attitude towards the sector as a whole.

1.3. Outline of the thesis

The thesis is made up by two main parts. Following this chapter will be a few pages presenting how I came about the data that will be discussed in this thesis, and thereafter our focus will turn to why microfinance is needed in India (which will constitute part one). This

¹³ I know from talking with clients and practitioners during my fieldworks (this note is purely based on experiences I made during the fieldworks which will be properly introduced in the next chapter ‘Methodology: Doing fieldwork in India- Reflections and lessons learned’) that formerly financial excluded poor people have gained access to the same banking services, pension schemes, types of insurance and so on as riches people have access to through the microfinance movement in the country. During my stay in Jaipur I learnt that, among other great examples, the organisation Aaina has helped raised the awareness of, and changed attitudes towards, people with disabilities. And that Aaina has formed a number of groups made up by disabled persons who now have become productive members of the community. That access to microfinance for housing, water and sanitation through the organisation ‘Habitat for Humanity India’ has contributed to improve the life quality for many in terms of hygiene and health, as well as reduced the work load for some household members which has resulted in children being able to attend school more frequently and women becoming more efficient when performing household chores. In Uttarakhand I learned how being part of a group have contributed to raise the voices and decision making power of poor oppressed women both in the household as well as in the community (they were, among other things, able to stop an abusing husband from making and selling alcohol), and how self help groups organising into federations have managed to push through, for example, that the government was to build a school in the locality. The federations were furthermore large enough to affect the outcome (local) elections, while being strong enough to resist political hijacking. In Kaleshwar, with the organisation HARC, I saw an example of poor clients running a prosperous business which marketed and sold produce not only in the locality but also in markets quite a bit away from the village. And I believe that the *rickshaw* pullers in Jaipur, paying 20 Rupees a day in order to lease it, would not have been the proud owners of their own *rickshaw* within a year had it not been for the ‘Apna Rickshaw Apne Naam’ programme of Kshatras Trust.

part (chapter 3-4) relies to some extent on basic economic theory as it explores terms that we need to be familiar with in order to examine how the microfinance approaches can, and do, reach people who used to be excluded from formal financial services. The second part (chapters 5-9) is mostly based on the two fieldworks I have conducted. The focus of this part will be to challenge the argued outreach by putting the theory into practice, and by examining the quality of the microfinance sector's financial inclusion.

More concretely the next chapter, 'Methodology', will be an introduction to the fieldworks I undertook in connection with this thesis, and the reflections I have done in this respect. In chapter three we will explore some basic economic theory which will explain why formal credit tends to flow toward the richer members of a community instead of to the poor. The calculations and the terms we explore in this chapter will serve as background information for the rest of the thesis, and the findings will furthermore be the point of departure for exploring India's formal financial sector in regards to rural credit delivery, and India's informal credit scene, both of which will be the topic of the following chapter, chapter four.

The first chapter in part two, chapter five, addresses the history of microfinance, the two approaches through which microfinance is provided in India and how the workings of microfinance is expected to correct for the inefficiencies that excluded poor from formal financial services prior to microfinance. Chapter six discusses the relation between the size of a microloan and the impact it has on the lives of poor persons. Chapter seven sets out to examine the quality¹⁴ of self help groups, and chapter eight takes a closer look at the competition that is going on between the providers of microfinance and the effects this competition have shown to generate. Ending off this thesis we will answer the four questions posted above; does the group lending approach correct for the market failures in the formal economy which excluded poor people prior to microfinance? and so on, because these questions all say something about the quality of the sector's outreach and will thereby enable us to determine whether or not the outreach of the sector is overestimated.

¹⁴ With the word *quality* in groups I refer to a strong saving and repayment discipline among the group members. This is properly defined in the respective chapter, but in short the quality of a group contributes to determine its sustainability, the potential empowerment of the members, and to reveal how well it will function as social collateral in terms of covering for members finding themselves in trouble of repaying a loan.

Methodology: doing fieldwork in India- reflections and lessons learned

I conducted two fieldtrips to India in connection with this thesis. The first lasted from July 2009 to December 2009. This was not one continuous fieldwork, but during these five and a half months I conducted several interviews with leading scholars and practitioners of microfinance, I spent four days with the NGO HARC in Uttarakhand (September 24-27), and I went to Dehradun to visit HARC's main office (November 21-23). The second fieldwork was conducted in Jaipur (June 23-25, 2010) where I attended a three days Annual Forum on Microfinance organised by Solution Exchange, United Nations. During these fieldtrips I mostly interacted with scholars, practitioners and policymakers, but both in Uttarakhand and during the Annual Forum I also got the opportunity to discuss with, and learn from, some SHG members.

In order to present how I came across the data I rely on in this thesis and the lessons I learned on the way, I have chosen to present the fieldworks through a 'road travelled approach'. By a narrative of my fieldtrips I believe I can be truer in my descriptions of the processes through which I gathered data than what a schematic presentation would allow me to be. Furthermore a narrative allows me to address lessons learned as I learnt them. Ending of this chapter I have addressed some additional reflections around my fieldwork, the roles I had in the field and the quality of the data I was able to collect.

2.1 Background

Basu and Srivastava argue that: "By far the most successful model of microfinance in India, in terms of scale and outreach, is SHG Bank Linkage, with other models, such as the 'Grameen-type' independent microfinance institutions, lagging far behind" (Basu and Srivastava, 2005, p. 11). This statement was the foundation for my initial research question; why has the much acknowledged MFI/'Grameen model' been so slow in getting a foothold in India compared to the locally tailored self help group-bank linkage model (SBLP)?

Before leaving Norway I read up on some of the newest publication concerned with microfinance and freshened up on what I believed to be a somewhat adequate knowledge of

Hindi,¹⁵ but I decided not to plan the stay in India as I had little idea about who to approach in order to establish a network of informants or where I would conduct the fieldwork. What I knew was that my main base would be an apartment in Delhi which I would to share with two fellow students, the rest I left up to fate. As I have travelled in India prior to this, and my experiences have been that India is a place where networking is easy, I did not think that poor planning would be a problem, rather I believed it to be a smart choice that would enable me to establish more and diverse contacts and thereby expand my knowledge of all aspect of the sector.

2.2 Landing on a research question

The first issue on the agenda after landing in Delhi was to establish contact with practitioners and scholars that could provide me with the insight I sought, as well as to find an NGO willing to include me in their work. I started out by sending e-mails to organisations operating in and around Delhi, and I exchanged telephone numbers with everybody that expressed an interest in my study. After having spent a month or so without getting in touch with people actually engaged in microfinance (which I now blame my poor preparations for), the girls I lived with and I met up with our teacher from the University of Oslo, Professor Zoller, who had come to Delhi. He introduced us to a friend of him, Mr. Gabar Singh Chauhan working at the South Asian Institute in New Delhi.

Mr. Chauhan put me in contact with a couple of scholars who agreed to meet with me. Initially I prepared for these meetings by reading up on the scholars' work and by preparing a tailored questionnaire that I thought would provide answers as to why the SBLP had become so popular in India. The end result was the same for each and every one of the first four interviews I conducted; the informants seldom found my questions relevant to their field of expertise. Even though I altered the questions after each interview, as my understanding of the sector grew, the mere fact that I had prepared concrete questions resulted in me having hard time improvising and in that the informants replied in very general terms. This is not to say that the interviews and the preparations did not prove helpful, but when I changed strategy and asked the informant to interpret overriding topics freely, the informants, each being an expert on a specific field, provided so much interesting knowledge on all kind of trends that my research question changed almost with every person I came in contact with. It was

¹⁵ Unfortunately one and a half year of talking absolutely no Hindi in Norway had affected my ability to speak Hindi as well as I believe I was able to during our Hindi classes in Jaipur two years earlier, but luckily the understanding of the language was still fairly (though not entirely) intact.

therefore not until I came home and listened through all the material I had gathered I decided that the topic of this thesis had to be a discussion on the quality of the outreach of the sector.

2.3 Language and expectations

After little luck getting a Delhi-NGO to include me in their work (becoming the researcher living amongst her informants) I went back to Mr. Chauhan. He knew a man from the village in which he grew up (Srinagar, Uttarakhand), Dr. D. R. Purohit, who currently was teaching at Garhwal University and was a board member of a NGO named HARC (Himalayan Action Research Centre). The day we were to meet in Srinagar, Dr. Purohit unfortunately experienced a death in his village. Still, as a favour/obligation to his friend in Delhi he contacted some people at HARC, found a bus, and sent my flat mate and research assistant for the trip Katarina Dogger Fürst and me on our way to a place named Kaleshwar with nothing but a couple of phone numbers and an address.

We arrived in the small village Kaleshwar early Friday morning, September 24th. Expecting to get some sleep and to walk around and get to know the place the first day, I called Dr. Arvind Darmora, who Dr. Purohit had told me to contact, to set up a meeting for the following day. By chance Dr. Darmora had a room at the hotel we stayed in and stood right behind me when I made the call. Two things happened then that I was not prepared for. First of all he did not speak English, and secondly he immediately dragged me off to meet the manager of HARC, Mr. Prakash Raturi.

The first day and a half in Kaleshwar most of the conversations took place in a mix of Hindi and 'Hinglish'. The language problems I experienced were to a certain extent overcome as I recorded most of the conversations which enabled me to listen to the interviews later in the day when I had a dictionary at hand. My insufficient Hindi did restrict me from asking certain follow up questions in the situation when I did not catch everything, or the exact meaning of what was being said, but luckily I had the opportunity to ask them and to clarify misunderstandings in the evenings as we all ate dinner together at about 10 pm. Furthermore, Mr. Tirpathi, who came to be my interpreter as he had good knowledge of English, Hindi and the local dialect, joined us in the late afternoon on the second day, and from that time on I had him at hand to clarify statements and to present my questions properly to the informants when they did not understand what I was trying to ask.

In some cases the language problems brought misunderstandings to the surface right away, but I also experienced that people 'faked' to understand questions I asked (both

because of my insufficient Hindi and their problems with English) and answered them in a way that made me interpret their answer as I thought (or even hoped) they meant. Tilde Rosmer writes about how we are unable to interpret something completely free of prejudices and in a perfectly objective way due to our nature as being rendering human beings belonging to a society (Rosmer, 2005, p. 50-52). I therefore tried to be persistent throughout the fieldworks with rephrasing questions to get confirmation on my interpretations whenever I thought that I had discovered a groundbreaking finding, or when I saw that the informant became uncertain. This method usually helped me realise my mistakes as the informants either answered the exact opposite to the ‘new’ question, or they confirmed my interpretation.

During the days I spent in Kaleshwar I met a lot of knowledgeable people. I got the opportunity to meet with three SHGs, Mr. Raturi (the manager), Dr. Darmora, Mr. Mahendra Singh Kunwar (mostly working at HARC’s headquarter in Dehradun), Mr. Tirpathi (the interpreter) and his older brother who was associated with a couple of NGOs in the area. On the third day of the Kaleshwar fieldtrip the people at HARC had furthermore arranged for me to visit an NGO, a State Bank of India representative, a Father and a Block Development Officer who were all stationed in a village a couple of hours further up in the hills.

2.4 Staying neutral

“Furthermore I will stay neutral to all information given to me, and produce the final text without any visible judgement.” I wrote this line for my Project description before I went on the fieldworks. As you will soon see, I failed badly at this with a Block Development Officer (BDO). One informant told me to ask the BDO (I thought) about the schemes that the government has for SHG clients, and he made me a bet that the BDO would not be able to answer the question. The former informant, whom I felt much respect and admiration for,¹⁶ told me that bad BDOs was a big hindrance to the SBLP movement, and I became very eager to confirm this accusation. The first question I asked the BDO was therefore about the government schemes, and he answered: “oh, you know, so many schemes.” There and then I assumed that he did not know his work, got the former informant’s accusation confirmed, and I did not understand why I had to sit there, so hungry, and converse with that man who clearly could not provide any useful information. It was during the following interview that day, with Father Francis, that I realised the mistake I had made with the BDO. He talked about how his

¹⁶ I think I did not stay neutral to the first informant because all the people surrounding him seemed to respect him so much, he was able to reflect well around a number of topics and he was willing to discuss sensitive issues with me that others before him had shunned.

animators (which is what he called the staff) often used the local BDO as a resource person and that the BDO was a very knowledgeable and helpful man. A bit confused I went back to the person who I thought had argued that the BDO was unfit to do his job, and this person corrected me and said that his critique had been directed at local bankers and had nothing to do with the BDO. Aukrust refers to a article written by Terje Planke that sums up where I feel I failed in this case: “We need to submit to informant’s understanding in order to access her perspectives, but we should never become our informants – no matter what” (Aukrust, 2005, p. 238).¹⁷ I swallowed raw what I thought one informant had said and let it affect my objectivity towards the BDO. As a human being I am not capable of processing every situation I encounter unaffected, but I realised after the meeting with Father Francis that I should not have gone into the first interview with a hidden agenda (which of course was a very unethical/unmoral thing to do), I should have been more in control of my body language regardless of how I felt, and I am certain that I missed out on information which could have benefited this thesis because of my prejudice and attitude towards the BDO. I learned an important lesson that day; I had (obviously) not done a good job keeping a ‘professional/neutral’ relationship to the people I met. I do believe that the experience in itself, if nothing else, was beneficial for the succeeding interviews I was to conduct. It made me more aware of my own limitations and the signals I was sending out both during interviews and when I was just hanging out with people.

2.5 Memory and research assistants

Despite being warned by our teachers before we left Norway, I went into the first interview thinking that I would remember what was said, how the room looked, and how the atmosphere was. I was wrong. According to Nielsen (et al.), Michael Agar points out that field notes often gets inaccurate as it is rarely possible to write down what is happening while it is happening. He argues that one is forced to write the information down afterwards when much is already forgotten (Nielsen, 1996, p. 107). Michael Agar is right. When we returned from Kaleshwar I sat down to transcribe the interviews, and the first thing I did was to delete an entire folder with over six hours of interviews. In panic I started retracing the day, but I soon found that I had relied too much on the recorder and did not have sufficient notes. I

¹⁷ Originally written in Norwegian: ”Vi må underkaste oss informantens forståelse for å få tilgang på hennes perspektiver, men vi må aldri bli som våre informanter – uansett” (Aukrust, 2005:238).

remembered fractions, but I kept thinking that it would have been so much easier had only someone been with me that day. This too, proved to be less true than what I imagined.

In an attempt to recapture some of the information lost, I went to Dehradun to meet up with the informants from HARC in their main office. I asked my other flat mate Hanne Karen Unhammer to come with me as a research assistant, and I checked the equipment thoroughly before we left for the meeting. Two out of three lines were indicating that the batteries on the recorder were good, the camera had available memory and our pens were writing, all of our pens were writing. The first thing that happened when we sat down to talk with the informants though, was that the recorder's batteries ran flat. It was not possible to delay so we had to continue and try to write down as much as we could. My biggest mistake here was that I had not considered that it was impossible for Hanne Karen to know what parts of the information that was most crucial to me. She wrote down as much as she managed trying to cover a bit of everything, and I just wrote down clues because I had enough with focusing on the conversation. Coming home looking over our notes I found that I had not been accurate, nor detailed oriented enough in my own notes, and that she had written down a summary of the conversation but thereby also left out the same details which I lacked in my notes. Having an assistant did help me to discuss and retrace the interviews afterward, but the accuracy and the memory of a recorder was by far the most valuable equipment I had in the field.

Even though it has been argued that a recorder might make the interview situation appear more formal which might make it tense,¹⁸ my experience in general was that all the interviews began somewhat nervous, but that after a couple of minutes both the informant and I began to relax and it did not make a difference whether the recorder was on the table or not. One factor which might have affected my findings though, is that some of the informants can have held back information as long as the recorder was taping. I only really experienced this once which was when the banker in Uttarakhand, after I had asked the last of my questions, took the recorder, turned it off and said: "Good, now we can talk more informal." Seeing that he had been so aware of everything he had said while the recorder was on, it is possible that others were too, but as I tended to stay for a couple of minutes after each interview to wrap things up and to thank the informant, I am under the impression that most of them spoke their mind even when the recorder was on because it was only during the interview with the banker that I felt that the on-tape informant was not the same man as the off-tape person.

¹⁸ Lectures in the course KOS 4002, spring 2009.

2.6 Networking

Prior to the Kaleshwar trip I experienced that few of the people I had contacted replied. I believe that this was mainly due to two reasons. First of all I was not pushy enough. When I did not receive an answer on my request per e-mail, I could have followed up on the phone and asked if the person had seen the mail. After that I probably should have called again to confirm that he had actually read the mail, and then I could have tried to set up a meeting. Second of all, I did not have a reference person to give the people I wanted to get in touch with. When I started taking advantage of networks that others had already built, people also started responding (as in Srinagar when Dr. Purohit arranged for me to visit with HARC). Back in Delhi I called up a man, Dr. Navin Anand at the UNDP, to ask him about a report that Mr. Kunwar had shown me in Dehradun. I started the conversation by saying that Mr. Kunwar had told me to contact him. Not only was Dr. Anand glad to provide me the report, he also offered me to use him as a resource person as he sat on much information and was a close friend of Mr. Kunwar. As it turned out, Dr. Anand is the Resource Person and Moderator for the microfinance community Solution Exchange, UN, and meeting him directly led, and enabled me to travel back for a second fieldtrip. Now, this is one of the problems with conducting fieldwork in unfamiliar places; it can take a long time before everything falls into place. Thanks to my clumsiness I had to travel to Dehradun where Dr. Anand's friend Mr. Kunwar was stationed and showed me the report. I would never have met Mr. Kunwar had it not been for Mr. Raturi's commitment to introduce me around in Kaleshwar, and had not Dr. Purohit experienced a death in his village I would never have been sent to HARC. Had Mr. Chauhan not grown up in the same village as Dr. Purohit, and ultimately been a friend of our Hindi teacher Professor Zoller, none of this would have happened.

I met Dr. Anand only two days before I had to return to Norway, but we kept in touch, and one day I found an e-mail in my inbox saying that "we are having our Annual Forum in June (23-25 June) in Jaipur. I will send you the invite. If you are in India during that period it will good to participate as you will be able to meet leading practitioners at one platform." As I returned to Norway I found that despite having learned a great deal during the first fieldwork, I now had even more questions than before. The Annual Forum, for which Dr. Anand was one of the main coordinators, provided the perfect opportunity to get those questions answered. The way this have affected my data is that the participants at the Forum were all leading practitioners in the field of microfinance. We did undertake a fieldtrip to Aapni Sahkari Sewa Samiti, Phagi, Jaipur, and visited with a female self help group, but except for this relatively

brief encounter, most of my data from the second fieldwork reflects the thoughts and concerns of practitioners, scholars and policy makers. This is also partly the reason why I have chosen to address the outreach of sector instead of focusing more on how microfinance affects the clients' lives in the social sense. During the Forum I got to do interviews, I listened to speeches, engaged in group discussions, had random conversations with the other participants and visited stands that some of the NGOs and MFIs had set up by. Unfortunately, I did not get the names of all the participants, and coming home relying on the recordings I found it quite hard to place all the voices to the correct man (there was somewhere around 70 men) or woman (I think I saw eight different women at one point or another during these three days).¹⁹ Nameless quotes from the Forum merely represent that I do not know who exactly that made the statement.

2.7 My roles in the field

During the fieldworks I held three different roles. I was perceived as a young, foreign student, a European scholar and a (female) friend. As most of my data is based on short interviews I was not given role as a person my informants confide in expect for when we were in Kaleshwar, so I mostly balanced between being a young student and a 'knowledgeable' scholar. What I noticed was that people spoke more openly when they saw me as a young nose student compared to when people saw me as a European scholar. At one time, just after having met Mr. Tirpathi (the interpreter) for the first time, I sat down to discuss SHGs with him and his brother. In the situation it became very noticeable that I had the role of somebody that was there to investigate their way of living. They acted humble, a bit nervous, and it seemed like they were trying to answer the things they thought I wanted to hear. I felt that these informants (none of them having a leading position in their community) answered hypothetical questions coloured by what I had told them that I was there to examine. I believe that realising, or identifying, the situation, at least made me somewhat able to overcome the problem as I began to rephrase questions from being hypothetical to ask them to retell concrete happenings from their own or their friends' lives.

¹⁹ A problem which refers to statements made during our group discussions, the bus ride we made in connection with our fieldtrip and the roundtable on the *State of the Sector Report 2010*, as that was when the most people were gathered and a lot of the participants shared their experiences and thoughts without stating their names.

Another example is how one man during the Annual Forum was under the impression that I actually had a voice in the UNDP.²⁰ I did not realise it at the time, but when I listened to the recording it became very clear that I had held a role as somebody he thought was in a position to help him. The way this affected the information was that he changed, or adjusted, his answers after my replies. When he talked about, for example, corruption in the area he would describe the phenomenon quite in depth, but when I asked how he thought that would affect the possibility of doing microfinance there, he quickly began to reassure me that corruption would not be a problem as it was not widespread at all.

Having the role of a young exited foreign student, on the other hand, I believe benefited the thesis greatly, and I resorted to taking on this role from time to time when it was not given to me naturally. I could ask ‘stupid’ questions and people began to explain whole processes in depth. The informants tended to express their own opinions more instead of referring to widely acknowledged attitudes, and some even expressed a need for making me aware that the microfinance movement was not working perfectly (as I had travelled all the way to India out of admiration and curiosity for it). Furthermore people expressed controversies which I suspect that would have been kept from me had I not held this role. In general people seemed more comfortable with lecturing, or teaching me, when I was only a student (which I greatly appreciate). This is not to say that I have swallowed every statement raw. I experienced people trying to fill my unknowing head with percentages and ‘facts’ which I soon found out to be quite misleading, but had it not been for the BDO incident though, I do not think that I would have work as hard to verify what people said during the fieldworks.

2.8 The validity of my data

The data in this thesis relies partly on what I learnt during these fieldworks, and partly on the literature and reports familiar to me. During the fieldworks I was able to meet with SHG members, people working as volunteers in NGOs, managers of NGOs (both small and large organisations), knowledgeable scholars, leading persons in MFIs, bankers and policy makers. During the Annual Forum Dr. C. P. Yoshi, Hon’ble Union Minister For Rural Development and Panchayat Raj gave a speech, and I was lucky enough to act as a Facilitator for the group which N. Srinivasan (a man I spent the first fieldwork talking about as ‘the king of

²⁰ My name was listed as facilitator for one of the groups during the workshops, an honour and a role that the Solution Exchange team probably delegated me as a welcoming gesture.

microfinance’ and never dreamt of ever meeting) was the Resource Person, Brij Mohan was the Chair and Dr. Daniel Lazer the Rapporteur. The people I talked with who represented NGOs were engaged in everything from working with people with disabilities, to housing microfinance, pension schemes and *rickshaw* leasing (on the path of becoming owners) programmes. I had the opportunity to talk with NGO staff whose primary occupation was to form and train SHGs that are linked with banks, and I spent time with people who promoted a community owned (and run) large business micro-financed by a formal bank. Participating at the Forum furthermore enable me to meet with people who came from all over the country, as well as with Indians living abroad.

As the range of people I had the opportunity to talk with, interview or merely listen to was quite diverse, so was the opinions they represented and the concerns they raised. I believe that this has helped me reach a fairly nuanced picture of the state of the sector. However, statements made by individuals cannot be said to be representative for the microfinance sector as a whole. People will present issues based on their own experiences and expectations, and this tends to colour the information they chose to pass on. What the things people told me allows me to argue though, is that the concerns they raised are present in some parts of the sector, the parts known to them. I know that people sometimes exaggerate or understate certain issues in order to create debates or to promote their cause, I also do this, but the data included in this thesis does not reflect the thoughts of just a single man or a single woman. Even though I have not included four of each quote stating more or less the same, all the quotes are representative for issues that was either debated (and for the most part agreed upon) during the Annual Forum, or that was raised on multiple occasions (for example both in Uttarakhand and in Delhi and/or Jaipur). When available I have substantiated the informants’ statements with discussions and arguments found in academic literature, articles, official websites, or reports,²¹ and the reason why I have chosen to include and debate statements which I have not found to be debated elsewhere is that even though they cannot be argued to be representative facts for the sector as a whole (as they are statements made by the relatively few individual that I happened to meet during the fieldworks), they do imply some tendencies or developments that I feel it is important to put focus. When possible I have included World

²¹ Authors natural also tend to focus on smaller parts of a whole as they have a point they wish to make by producing their text, so I have been persistent in reading literature that has allowed me to address topics from as many angles as possible. As some of my data is based on reports and articles given or suggested to me by my informants, I have made sure that the texts I refer to in this thesis have been written by relatively acknowledged authors and/or practitioners that have backed up their arguments with substantial references and nuanced discussions.

Bank data, data provided by the National Sample Survey Organisation, by the National Bank for Agriculture and Rural Development or by the Reserve Bank of India to suggest some kind of scope of the phenomenon under debate,²² but in other cases though, when I have not been in a position to argue anything except that it does in fact take place, the statements are included here because I am under the impression that they represent a phenomenon which might be sizable and therefore deserves the attention.

Personally I often find it beneficial to substantiate tendencies and arguments through the social economics familiar to me. For me it makes more sense to discuss, for example an SHG, when I am in a position to explain the mechanisms behind why providers of microfinance rely on the group lending approach, and how that is expected to correct for the flaws that excluded poor people from financial services prior to microfinance. The way I have used social economics in this thesis is by challenging general theory by applying it to an Indian context. Even though a group lending approach in theory counters banks' imperfect information of poor borrowers, does it work in practice? In this thesis I have relied on the relevant algebra that can be found in the books *Development Economics* (Debraj Ray, 1998) and *The Economics of Microfinance* (Armendáriz de Aghion and Morduch, 2005). This is seen in relation to statements made by my informants and the relevant literature concerned with social, economic and political affairs in rural India. As this thesis will explore whether or not the outreach of microfinance is overestimated, it will not primarily engage in the typical social issues, empowering of clients versus making their lives even more rigid, debate. That the sector will be at the centre of attentions rather than how it affects the clients' lives merely reflects that my data mostly comes from practitioners rather than clients.

²² It is mostly in this respect I have had to rely on internet sources, but I have also relied on them to discuss current developments in the sector when contemporary (printed) literature is not available. The benefit with internet sources is that they typically are more updated. Some of the articles I rely on (for example one of the articles written by N. Srinivasan) are furthermore posted on acknowledged online discussion platforms. The advantage with this is that they are commented heavily on by others which provides a broader perspective of the topics under debate (even though I have not used and relied on random comments in this thesis, reading them have been beneficial as some comments have inspired me to approach certain debates from more angles than I initially was aware of). I do regard the information published on the websites I refer to reliable.

Why does not capital flow naturally to the poor?

This chapter is a discussion of why formal credit tends to flow away from the poorer segments of the population and towards the richer; even though basic economic principles suggest that it should be the other way around. The terms we explore in this chapter will serve as background information for the rest of the thesis. The findings in this chapter will furthermore be the point of departure for exploring India's formal financial sector in respect of delivering rural credit and exploring India's informal credit scene. The next chapter concerned with India's formal and informal credit markets will make it clear why microfinance has evolved as a movement for financial inclusion in the country.

3.1 Diminishing marginal returns to capital

In basic introductory economics one learns about the principle of diminishing marginal returns to capital. This principle says that enterprises with relatively little capital should be able to earn higher returns per dollar (additional unit of capital) invested than enterprises with a great deal of capital already utilised. The principle derives from the assumption that the production function is concave in its form, as I have illustrated in figure 3.1.1. To set the principle of diminishing marginal return to capital in a context, and to show how the assumption of a concave production function can be legitimised, we can picture an Indian tailor who is working from home sewing/repairing *salvar-kamieezes* and *sarees* for the other villagers.

Initially this tailors means of work was a needle, thread and a scissor. In this example the tailor gets a hold on 1000 Rupees, and whether she has borrowed the money or saved it is not a concern as of yet. If she uses the 1000 Rupees to buy a used sewing machine, the tailor will be able to produce/handle many more units of clothes per week relative to the amount it was possible for her to finish when she made everything by hand. The next 1000 Rupee surplus she is able to gain, she also wishes to invest in her business.²³ The tailor chose either to use the 1000 Rupees to hire an assistant to measure clients and cut the fabric for her, or she buys a scissor sharpener, a new desk or maybe a more comfortable chair in order to further

²³ As I merely aim to explain diminishing marginal return to capital with this example, I do not take into account external factors that might pressure a poor Indian woman to make investment decisions that do not maximise her revenue (in this lays also the not very farfetched assumption that the lady knows what she needs in order to work more efficiently).

increase production. It is very likely that she will work more efficiently on a desk that is not crooked and unsteady, or that having a guy to measure, draw and cut will save her some time per unit of clothes she makes, but the incremental/marginal increase in revenue is not likely to be as great as that generated by the sewing machine, the first 1000 Rupees she invested. As all external pressure and obligations are held aside in this example, we can assume that the tailor expected to gain more from buying a sewing machine than what she expected to gain from investing in a scissor sharpener or hiring an assistant, if it was not so, she would not have prioritised to use the first 1000 Rupees on the sewing machine. The example thereby gives us that, at some point, each additional unit of capital invested (marginal cost) will ultimately bring smaller and smaller incremental, or marginal, gains. The theory that the steepness of the production function's slope decreases as more and more capital is invested is therefore very plausible.

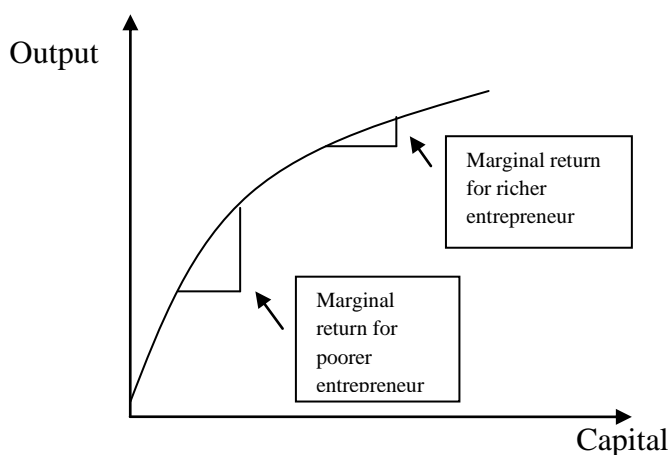


Figure 3.1.1

The incremental gain relative to capital finds relevance in this thesis because it can contribute to determine a borrower's ability to repay a loan. Seeing that a poor entrepreneur in theory should be able to pay higher interest rates on a loan, as his marginal return to capital is higher than what a rich entrepreneur's marginal return is, one can find the need for microfinance somewhat surprising. Believing that this basic tool of economics is correct, why then, does not capital from banks flow naturally towards the poor?²⁴ Why do large companies or rich farmers have a far easier time obtaining formal credit than self employed village tailors?

²⁴ The question is posted and answered by Armendáriz de Aghion and Morduch in the book *The Economics of Microfinance*, 2005.

3.2 Theory put into practice

The convenient form of the production function in figure 3.1.1 conceals the assumption that everything but credit is held constant. Out in the real world, and in this case in an Indian village, one is not likely to find a homogeneous society in which everybody has the same financial literacy, business savvy, commercial contacts and access to their needed inputs. When everything except the amount invested is not held constant, and we do take into account where the tailor gets the money to buy the sewing machine, the scenario changes. If the tailor borrowed the 1000 Rupees she invested, in coherence with the argument, she should still be in a position to repay the loan at relatively high rate of interest. This assumption though, depends on the loan being taken from a formal bank whose only prerequisite for lending out the money is that it will be repaid with its respective interests. If we open for the possibility that she borrowed the money in the informal sector, and/or we open for situations in which lender and borrower also do business in other markets, a neighbour's or a family member's expectation of borrowing surplus money, sudden sickness in the household, a husband that controls the family income, alcoholism, or for example the risk that another village tailor gets a better reputation than she, the tailor might run into repayment difficulties regardless of the interest rate she is faced with. How severe her situation will get, or whether she will have trouble repaying at all, will differ with the arrangements she has made with others and the context she lives in. Furthermore one should keep in mind that there can be production opportunities in which technology exhibits increasing returns to scale over a relevant range. If this is the case with an occupation in a somewhat isolated village (in the sense that the poor entrepreneur would have to travel far in order to sell her produce in a different market), the poor resident would most likely be unable to compete with a better-off entrepreneur and would have lower marginal returns despite having less capital.

Even if we do argue that poor entrepreneurs can be expected to have high marginal return to capital, like the village tailor if she borrowed 1000 Rupees from a bank and did not have to worry about external draining on her cash flow, there are some dominating factors that make formal providers of finance reluctant to engage in business with the poor.²⁵ From the bank's point of view the main obstacles have to do with risk assessment, imperfect

²⁵ I refer to a person who do not own any valuables, savings or any assets that a bank will find satisfactory as collateral for lending out money when I use the term 'poor'. A poor person who owns the plot of land his house is build on is usually considered to be 'relatively poor' as he in fact owns land, even though he might not have any savings and lack a steady income flow. In this respect, if the output from the man's plot of land cannot feed the household, is mortgaged to, or controlled by, others, or it is considered useless or unacceptable as collateral in the formal sector and the man do not have any other assets that the bank will accept, he is included in this reference to poor persons.

information, and lack of collateral and high transaction costs. As a point of departure to reflect around these problems I have found it beneficial to introduce two terms, namely ‘adverse selection’ and ‘moral hazard’ (Armendáriz de Aghion and Morduch, 2005, p. 37-46), which both are caused by information imperfections. We will first explore in what ways adverse selection affects a bank’s decision making process when it comes to handle (or not to handle) poor clients. The next step will be to account for the ways in which moral hazard further contribute to exclude certain layers of the population from the formal economy.

Adverse selection is what occurs when banks are unable to determine the risk it encounters when lending money to clients (Armendáriz da Aghion and Morduch, 2005, p. 37). Banks would prefer to charge riskier customers a higher interest than safer clients in order to compensate for the added probability of default, but banks often suffer from imperfect information about poor villagers’ ability to repay as they do not have access to credit records that can be tracked. If they were to go to each applicant’s village and dig up the required information, that would hardly be obtainable in a cost-efficient manner, and further the banks have little guarantee for that the people they speak with in the village actually will be truthful. Banks therefore face a situation in which they will have to increase average interest rates for all just to be sure to cover the most risky borrowers. By raising average interests for everybody, though, the banks are likely to drive safer costumers out of the formal credit market and thereby get stuck with the ones most likely to default.²⁶

A normal way in which banks compensate for risk is by demanding collateral in return for lending out money. Unfortunately, this requirement cannot always be met by the financially weakest sections of the population who do not have sufficient assets to put forward as collateral. The other direction that banks therefore often pursue, which at least if nothing else is an understandable choice due to restrictions on interest rates, high transaction costs, imperfect information and lack of collateral, is to simply direct their services to wealthier clients and treat the poor as financially untouchable.

The second term, moral hazard, refers in this relevance to the problem that occurs when banks are unable to ensure that a customer is putting inn all the effort required for his or hers investment to be successful, or when banks are unable to observe the realisation of project returns. Ray describes the problem of moral hazard, or as he also refers to it ‘the

²⁶ Armendáriz da Aghion and Morduch, 2005, p. 41-43, provides a numerical example that illustrates why safer clients get driven out of the market when banks are unable to discriminate against more risky costumers. As this clearly shows the math that works behind banks behaviour I have included a summarised version of the example in the ‘Appendix’ of the thesis (Appendix 1).

problem of hidden actions' in the following way; "the benefit of a transaction to one party depends on some action taken by the other party; however, the latter may not have any incentive to take beneficial action after a contract has been signed between the two" (Ray, 1998, p. 464).

The problem that banks face, which in turn have consequences for the rest of the population and in this case especially for the poor without collateral, is to what degree moral hazard will affect the utilisation of the loans provided. One can expect that a man, who invests a relatively substantial amount of his own saving in a project complementing the money he has borrowed, or who has put forward valuables as collateral, will work harder to succeed with his project than a person who only spends money borrowed. This assumption naturally favours the better-offs with savings and assets when it comes to borrowing in the formal sector.²⁷ However, personal investments and commitment does not automatically translate into the success of a project. Banks may therefore experience to encounter information gaps at two basic levels. There is lack of information regarding the use to which a loan will be put (utilisation), and regarding the repayment decision. With respect to the latter, Ray introduces the term 'strategic default'; a situation in which the borrower can repay but do not find it in his interest to do so (Ray, 1998, p. 529, 540).

If a bank experience strategic default from a poor man who has borrowed a small amount, let's say 500 Rupees, the bank will often end up having to bear the loss. In its attempt to regain the loan the bank can drag the default borrower to court, but the value of the time spent on a trial and the money it costs to pursue the recovery of the loan will by far exceed the 500 Rupees lent. Of course the borrower might go to jail, but it will not change the fact that the man does not have any valuables that the bank can seize and sell. Even if the bank has contacts in the borrower's village that can make life hard for the poor guy, it will not make the bank recover its money when the borrower is flat broke. In districts where it is difficult to enforce contracts due to a weak judicial system, this problem is just made worse as people might see the lack in implementation of regulations and punishment as an incentive to default. As banks do not receive collateral, and in most cases are unable to monitor the borrower's actions, the problem of hidden actions contributes to banks' reluctance to serve poor.²⁸

²⁷ However, it is also a fairly common assumption that if poor are given half a chance, no one will strive harder to succeed if that means that they might have a chance to climbing out of poverty.

²⁸ To see more on moral hazard, Ex ante and Ex post moral hazard and numerical examples, please see Armendáriz de Aghion and Morduch, 2005, p. 43-46.

To sum up; money tends not to flow naturally from banks towards the poor because of market imperfections in the formal economy. There are certain conditions under which markets fail, or functions at an inefficient levels, such as when there are incomplete information, strategically behaviour and incentives that affect the decision making process of the actors negatively (in the sense that peoples actions, the bank's and borrower's both, hinder financial inclusion of the needy). The main concerns that seems to hinder poor from accessing formal finance appear to be the information available to banks about the risk of lending to a potential client, the transaction costs involved in getting the required information about a customer (which of course can be thought of as even greater when one assume that poor borrowers mostly wish to borrow small amounts) and the poor's lack of collateral. As posting collateral in many cases could counter the problems of both moral hazard and adverse selection, lack of collateral rise up as the dominating excluding force. The reality that poor more often than not lack collateral results in situations in which information about the borrowers act as the main market imperfection that make banks direct their services towards the better-offs in the community. I will in chapter five explore in what ways the microfinance movement aim at providing innovative solutions to work around these problems, but let us now turn to some of the steps taken by the Indian government in its attempt to ensure that money do flow in the direction of the country's rural poor, and explore how India's informal credit sphere nevertheless might be better fit to provide the financial services that poor require.

India's economic spheres: the formal and the informal providers of financial services

As the informal economic sphere and the formal arena often overlap it is not possible to draw a clear cut line to separate the two, but as a guideline the economic discipline tends to refer to the formal sector as a sphere in which people operate “under the umbrella of accepted rules and regulations imposed by the government” (Ray, 1998, p. 346). As a counterpart to this, the informal sector is regarded as an unorganised and non-institutional sphere that includes traditional, rural and subsistence socioeconomic activity (Germidis, Kessler and Meghir, 1991, p. 39-40). A well developed and inclusive financial system is associated with faster economic growth for the country, and less biased income distribution among a country's inhabitants. An incorporating formal financial system is furthermore expected to reduce damaging concentrations of (economic) power.²⁹ A concentration of economic power can be considered damaging as it might enable ‘superior’ villagers to take advantage of their less fortunate neighbours who depend on the better-offs for work, loans, alms, advices or the like, when they do not access formal financial services.³⁰ A popular expression for this kind of dependence is ‘patron-client relationship’.³¹

This chapter begins by exploring the extensive banking system in India. Thereafter we will address the present formal financial situation which will make it clear why one can argue that the financial sector has not been able to achieve the financial inclusion that policy planners have sought.³² From there we will turn our focus to the informal economy. We will

²⁹ The reason why I have put the word ‘economic’ in parenthesis is that the typical powerful villager in rural India not is exclusively superior in terms of economy, but most likely also in the social and political sense as well. The three characteristics are often intertwined, and having one or more of these characteristics is likely to reinforce the others.

³⁰ The reliance on better-off villagers is often present regardless of whether or not a person has access to formal services, but the *option* and the *possibility* of depending less on an informal source is what is left out when people do not have access to formal services.

³¹ I will discuss the relationship between patrons and clients in dept in the last part of this chapter, but for now please note that there is a mutual dependence between a patron and his clients, the latter not always being inferior the former, though the trend is that clients depend more on the patron than the patron does on a particular client.

³² Although microfinance now is provided through the banking system I have held it aside here as my aim is to address the flaws in the banking sector that advocate a need for an alternative approach in order to reach and bank poor people. For the same reason, as well as the fact that I have limited space to elaborate on, I have also chosen not to engage in a discussion of India's post offices even though they also provide some financial services.

discuss how moneylenders help to fill the gap for finance left by the formal institutions. This will naturally also require a note on moneylenders and the ways in which they do business. The chapter ends in a discussion of how informal lenders also sometimes fail to provide the poor with the services they require, or at least do not provide them on beneficial terms.

4.1 The formal economy with focus on rural areas

The 61st round of National Sample Survey Organisation's (NSSO) survey estimated that 27.5 per cent of India's population is poor. Of the people living in rural areas, 28.5 per cent is recognised as being poor, while for urban areas the number is 25.7 per cent (Srinivasan, 2008, p. 1). When we take into account that about 70 per cent of India's population live in rural areas we can estimate that just above 72 per cent of all the Indians living in poverty resides in the countryside.³³ Policies aimed at financial inclusion have therefore naturally had a rural focus. The present banking infrastructure is vast and consists of cooperative banks, commercial banks and regional rural banks. The shape we find today has developed over time and through various policy initiatives, and I will briefly account for the most relevant for this thesis next.

4.2 The Indian banking system with focus on rural credit delivery

Cooperative banks are often regarded as the premier institutions for rural credit disbursement in India as the first legislation on co-operation was passed by the state in 1904 (Fisher and Sriram, p. 2002, 35; Jha, 2010, p. 40). Today there are more than 105 735 cooperative societies in the country (Karmakar, 2008, p. 35), which are organised and managed after the principle of co-operation, self-help and mutual help as part of the objective to provide a credit

³³ To calculate the percentage of the poor Indians living in rural areas I have had to rely on estimated numbers. As explained in the introduction to this thesis I was naturally unable to find the exact number of people living in India, not to say an accurate ratio between rural-urban residents. Therefore I decided to rely on the heavily accepted assumption that about 70 per cent of India's population live in rural areas, and that the population now counts 1 155 347 678 people as per the World Bank's estimates (World Bank, 2010b, [online]). To come to the conclusion that approximately 72 per cent of India's poor live in rural areas I made the following calculations:

1 155 347 678 the total population – 30 % living in urban areas \approx 808 743 376 people living in rural areas.

1 155 347 678 total population – 808 743 376 living in rural areas = 346 604 302 living in urban areas.

Then I calculated that 28.5 % of the 808 743 376 people ($808\,743\,376 \cdot 0.285$) equals approximately 230 491 862 poor people in rural areas, and that 25.7 % of the 346 604 302 people ($346\,604\,302 \cdot 0.257$) gives about 89 077 306 poor in urban areas.

By adding the number of rural poor to the number of urban poor I found the total number of poor in India:

$230\,491\,862 + 89\,077\,306 = 319\,569\,168$. Taking the number of rural poor, divided by the number of total poor and multiplying the sum with 100 we find the percentage of all poor residing in rural areas. ($230\,491\,862$

$/319\,569\,168) \cdot 100 = 72.125\ldots \approx 72,1$ %. This number might be a bit higher. Recall that we in the introduction found that the total number of poor in India is 317 720 611 (if 27.5 % of the total population is poor), relying on this number instead of rural poor plus urban poor we find that $72.545 \approx 72.5$ % lives in rural areas.

delivery system that is operating at the door step of the farmer.³⁴ According to Banknet India ((date lacking), [online]) they also aim at making such credit available relatively cheap since the cooperatives, as a principle, do not pursue the goal of profit maximisation. In 1951-1952 the Reserve Bank of India (RBI was established in 1935 and envisaged a special role in developing the agricultural credit sphere) organised an All India Rural Credit Survey which reported an utter insignificance of the cooperatives in providing rural credit as the banks' share in the rural credit market turned out to be as low as 0.9 per cent (Jha, 2010, p. 42; Dhage and Lobo, 2010, p. 215-216).

The Government of India (GoI) decided that they needed to take further action to ensure the unbanked population access to financial services and decided to nationalise the commercial banks that were active in the country. Furthermore the RBI initiated priority sector lending norms and concessional interest rate for the weaker sections. The goal of the nationalisation was to improve the rural access to credit through priority sector lending and healthy competition.³⁵ This transformation of the banking system happened in phases beginning with the 14 largest commercial banks in 1969, and in order to push rural branch expansion, banks were required to open two rural branches for every one branch opened in an urban area. This has lead to the establishment of 20 253 rural, and 12 522 semi-urban branches of 99 commercial banks across rural India (Karmakar, 2008, p. 35).

Notwithstanding the expansion though, the commercial banks failed to fill the gap generated by the cooperatives in making credit available to the masses of the rural population. Therefore, to further complement the provision of rural credit, the government passed the Regional Rural Bank Ordinance in 1975, which was later replaced by the Regional Rural Bank Act, 1976 (Jha, 2010, p. 43). The Regional Rural Banks (RRBs), which are established and maintained with very large, continuing government investments, were set up to provide subsidised loans to small and marginal farmers and to landless labours (Robinson, 2001, p. 211). They are unique institutions in the sense that they are set up as local banks aiming at combining the same familiarity with local conditions which the cooperatives possess, while providing the commercial range of operations (Jindal, 2008, p. 67; Jha, 2010, p. 44). The

³⁴ The cooperative credit body is made up by a 3-tier structure. The Primary Agricultural Credit societies (PACs) operating at the grass root level, followed by Central Co-operative Banks at the district level and the State Co-operative Banks at the Apex-, or state level. Moreover the cooperative credit structure is divided into two separate arms, one for short term credit and another for long term credit.

³⁵ The nationalisation had four main objectives. First it was to prevent a few corporations from controlling all the banks, secondly the government wanted to mobilize public savings, thirdly they aimed at limiting the concentration of wealth and economic power by using resources mobilized by banks to achieve egalitarian growth, and fourthly they wished to pay more attention to priority sectors as agriculture and small industry (Basu, 2008, p. 20).

network of Regional Rural Banks consisted of 14 446 branches as on March 31th 2004 (Jha, 2010, p. 44).

According to Rao there is now at least one retail credit outlet on average for every about 5 000 persons living in rural areas (Rao, 2008, p. 58). Nonetheless, Basu argues that the majority of the rural population appears not to have access to finance from a formal source. “Indeed, bank branches in rural areas appear to serve primarily the needs of richer borrowers: some 66 per cent of large farmers have a deposit account; 44 per cent have access to credit. Meanwhile, 70 per cent of marginal farmers do not have a bank account and 87 per cent have no access to credit from a formal source” (Basu, 2008, p. 23).³⁶ In one of the thematic workshops I attended during the Annual Forum on Microfinance, Prof. K Elumalai (who acted as the chair person for our group that focused on ‘Credit’) explained the exclusion, and self-exclusion, from formal banks in the following manner:

We all know it very well. We have all types of financial institutions [naming all the different forms and subtypes of formal banks]. In addition we have the moneylenders who play a very important role. As of the RBI report, the RBI acknowledge that despite so many institutional missionaries in this country, more than 50 per cent of the credit is met through the moneylenders only. Therefore their [the banks’] primary job is not done, even though we have all these missionaries with us. Even today the farmer for his basic lacks, whether it is for health or for providing education for his children, he early morning at the time of sunrise goes to the moneylender. And why he goes to the moneylender? Because the moneylender does not insist on security, he does not give for any loan applications and whatever the money is demanded it is given, *immediately*. Whereas any person wanting to go, first of all they are shy of going to the banks, whether it is a public sector bank or any bank, the reasons are many. Even the bank officers they don’t give proper treatment to the poor, which is the main reason. Second reason, for the bank it takes months to get it [the loan], and if you go to the bank and you ask for 10 000 Rupees, you will be given 5 000 Rupees only. Remaining 5 000 will go to somebody else, but that is another matter. The banks will lend at rates of 12-14 per cent, but if you add the time spent going to the bank, the days you go the wage is gone, you need to see the cost of the wages for the numbers of times spent for travel, and also the cost of travel. [...] Banks are there, but the banks are unable to meet the basic needs of the common man [in reference to extensive paperwork, demand for collateral, not providing loans for purposes such as marriage, hospital bills, education etc.].^{37,38}

³⁶ Data collected from World Bank and the National Council of Applied Economic Research - the Rural Finance Access Survey (RFAS) 2003 which covers 6 000 rural households in Andhra Pradesh and Uttar Pradesh (Basu, 2008, p. 22-23).

³⁷ Jaipur, 23.06.2010.

³⁸ I will suggest the following literature for supporting and verifying Prof. K Elumalai’s statements;

-Regarding corruption/bribes, reluctance to serve poor, lack of collateral, and cumbersome, untimely and costly procedures for opening an account or seeking a loan see Priya Basu, “*A Financial system for India’s Poor*,” 2008, p. 21-26.

-Corruption is also addressed by Thomas Fisher and M.S. Sriram, “*Introduction to the financial sector in India*,” 2002, p. 39.

-The cost of having to make multiple trips to the bank in order to obtain a loan is documented by Marguerite S. Robinson, “*The microfinance revolution*,” 2001, p. 211.

- For a broader understanding of the connection between subsidised credit and financial provider’s preference to serve non-poor see Armendáriz de Aghion and Morduch, “*The Economics of Microfinance*,” 2005, p. 8-11.

4.3 Maturing of the banking system and the present financial state

In July, 1991, the Government of India (GoI) introduced a large variety of schemes to liberalise its economic and political power. For the banking sector the liberalisation meant that private sector banks and new foreign banks were permitted to enter the previously monopolistic market, and that greater competition consequently got infused in the banking system (Jha, 2010, p. 49). The GoI also made it easier for banks to reach poor clients by in the year 2000 declaring that priority sector lending includes: “Micro-credit provided by banks either directly or through any intermediate; Loans to self help groups (SHGs) / Non Governmental Organisations (NGOs) for on lending to SHGs” (RBI FAQs, (date not available), [online]). As banks are obligated to ensure 40 per cent of the total credit to priority sectors (with 18 per cent for agriculture) through priority sector government schemes, this announcement enabled banks to reach their targets by providing MFIs with bulk loans, and/or have formed and trained SHGs linked to them at little or no cost to the bank under the SBLP. In addition to this, NABARD provides subsidised refinancing support to banks for loans made to SHGs (Harper, 2002, p. 176).³⁹

The pressure from above and the competition from within the banking sector seem to have led many banks to engage in finding new and creative solutions for inclusion of the low-income population who do not live close to a rural bank outlet. Though some financial providers still are at an early stage when it comes to developing and taking advantage of new technology, services like mobile cellular banking, mobile transaction devices, Banking Correspondents and Banking Facilitators,⁴⁰ ‘low limit credit cards’, etc. are strongly contributing to reach formerly unreached borrowers (Srinivasan, 2008, p. 109-114).

³⁹ NABARD was established in July 1982, as per recommendations of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development. The Committee concluded that “new arrangement would be necessary at the national level for achieving the desired focus and thrust towards integration of credit activities in the context of the strategy for Integrated Rural Development. ... The Reserve Bank had onerous responsibilities to discharge in respect of its many basic functions of central banking in monetary and credit regulations and was not therefore in a position to devote undivided attention to the operational details of the emerging complex credit problems” (NABARD: Genesis and Historical Background, (2007), [online]). NABARD was to attain to the entire undertakings of the Agricultural Refinance and Development Corporation and the functioning of the RBI relating to refinancing co-operatives and the RRB (Jha, 2010, p. 44-46).

⁴⁰ In short a Banking Correspondent or a Banking Facilitator can be understood as someone, for example a shop keeper or a retired government official, who provide or promote services on behalf of a bank in a village where the bank does not have a branch. The difference in terminology has been summarized in *Microfinance India – State of the sector report 2008* (p. 70), as follows: A BC can; identify clients and activities, process applications, form groups, disburse small value loans, recover loans, collect small deposits, sell insurance products and handle small remittances. The BF’s three first activities are; verification of primary client information, creation of financial literacy and debt counselling and follow-up for recovery of loans. The role of the BC is to put through transactions as agents of a bank and he can bind the bank in finance transactions. The BF on the other hand cannot put through transactions and cannot bind the bank as he is not authorised to deal with money.

India is presently one of the world's fastest growing economies with an annual average growth rate of more than 8 per cent. In the last three years the Indian economy have preformed creditably with a 9.6 per cent growth in gross domestic product (GDP) during the financial year 2006-2007, 8.7 per cent in 2007-2008, and a 6.7 per cent growth rate during 2008-2009 (Srinivasan, 2008, p. 1).⁴¹ The growth rate in agriculture (forestry, hunting, fishing or cultivation of crops and livestock production) during 2008-2009 though, experienced a significant decline to about 35 per cent of the previous year when it registered a 2.6 per cent growth in GDP (Srinivasan, 2009, p. 1; Srinivasan, 2008, p. 1). That about 70 per cent of the country's population, the approximate percentage residing in rural India,⁴² is contributing to less than 20 per cent of the overall growth GDP clearly reflects that the country's enormous institutional financial structure is not inclusive enough,⁴³ and it implies that the wealth is concentrated with elites in the cities.

Public sector banks, including nationalised banks, the State Bank of India and Regional Rural Banks, accounts for 73 per cent of the commercial banking and 52.4 per cent of the assets of all financial institutions in the system, and they thereby dominate the banking system (Basu, 2008, p. 21). Keeping the majority of India's banking sector under government control underpins Basu's argument that there is a belief that banks will serve the rural poor and small-scale industry only if they are mandated by policies to do so (Basu, 2008, p. 21). This stance on banking, the so called 'social banking', has formed the basis for maintaining a government-dominated banking system in which suggestions of bank privatisation are being branded as 'anti-poor' (Basu, 2008, p. 21). At the same time, government policies to support rural lending through their incredible network of bank branches, such as the priority sector credit schemes, do not appear to have realised their full potential.

Year after year, banks report having fulfilled the priority sector lending targets. But it seems they are able to get round the target by subscribing to other eligible instruments, for example, by investing in bonds issued by apex banks such as the National Bank for Agricultural and Rural Development

⁴¹ The decline should be seen in connection to the global financial sector melt down during in which many economies around the world registered a decline in their GDP. N. Srinivasan, the author of *Microfinance India - State of the Sector Report 2008 and 2009*, argues that India's large domestic market, and the creditably swift actions taken by the GoI and the RBI in sustaining liquidity flows and greater public expenditures, ensured that India's economy performed commendably under difficult global conditions (Srinivasan, 2009, p. 1).

⁴² There are of course be some non-agricultural activity going on in rural India, but I am under the impression that most rural residents included in the formal economy conduct work that will be included/calculated in the country's agricultural growth.

⁴³ There is some confusion as to this number. If growth in agricultural GDP only is 35 per cent of 2.6 that would result in a 0.91 per cent growth during 2008-2009, which again is 13.6 per cent of total GDP growth that year (to find the percentage: $6.7 \times X / 100 = 0.91$ gives $91 / 6.7 = 13.582$). According to World Bank webpage though, growth in agricultural GDP as percentage of total GDP is 17 per cent, and they report overall growth in GDP to be 7.7 per cent as of 2009 (World Bank, 2010c, [online]; World Bank 2010d, [online])

(NABARD) and the Small Industries Development Bank (SIDBI), instead of direct lending (this is expected to change, in light of the recent policy that makes investments in bonds issued by certain institutions ineligible for classification under priority sector lending). Even when banks do lend directly to priority sectors – for example, to agriculture- the benefits tend to be captured by the larger and more prosperous farmers, while marginal and small farmers remain largely excluded and have to rely on moneylenders (Basu, 2008, p. 27).

A way to tackle this problem, Basu suggests, can be by making priority sector lending obligations tradable. The most competitive lender would get paid by the banks that are less well-placed to effectively take on their priority lending requirements (Basu, 2008, p. 30). Basu might be correct in her assumption that both banks and poor would benefit from this solution, but I will suggest that making lending obligations tradable must be done with some caution. One could end up in a situation in which all branches operating in a difficult geographic environment might find it advantageous not having to struggle with reaching the unbanked, thus by getting rid of their quota they legitimise not having to serve certain segments of the community. Furthermore it might contribute to increase the already excessive competition that is going on in certain ‘easily reached’ areas.⁴⁴

As it is a given that all the segments of a country need to develop for the country to experience overall economic development, it should be needless to say that it is essential that further agricultural development takes place in India. Microfinance has emerged partly as an answer to the large gap between the demand for financial services compared to what and who is being supplied by the formal banking sector, and partly as an answer to dealings in the informal credit sphere. The next part of this chapter will explore how informal moneylenders are perceived, how they might be better fit than the formal banks to serve the rural poor, but also in what ways the services they provide are insufficient to secure the unbanked population access to the financial services that they require.

4.4 Moneylenders filling the gap for finance left by the formal financial sector

Even without access to financial services through the banking system, poor households seldom lack financial intermediation all together. They typically have multiple credit sources in the village economy, as well as ways to save and insure.⁴⁵ Introductory in this chapter I pointed out that the informal sector is regarded as an unorganised and non-institutional sphere, but although the Indian informal financial market is uncontrolled and unregulated by

⁴⁴ We will discuss competition at length in chapter 8 named ‘Competition leading to an overestimated outreach’.

⁴⁵ The alternatives to the formal sources can be pawnbrokers, professional moneylenders, landlords, shopkeepers, traders, employers, kin, neighbours and/or friends who are willing to provide the person in need with money, food, work or other necessities

the formal sector, it cannot be said to be completely unorganised. Within the informal commercial market we find dynamics of local socioeconomic processes, political alliances and associated information flows which creates market shares that tends to be controlled by particular patrons. As the patron often is regarded as a political, social and/or economical superior in the locality, other less fortunate villagers often turn to him in need of (financial) assistance. One can therefore argue, as Robinson does, that social networks and alignment, political alliances, religious affiliations and landlord-worker relationships among other bonds are contributing to form part of a local political economy (Robinson, 2001, p. 50, 131-132).

If the Indian rural informal credit market was small, or if it was large but characterized by free competition, we would not have to bother with a part dedicated to moneylenders in a thesis on microfinance. But numbers show that the overwhelming majority of India's population live in rural areas, that most of the people excluded from formal financial services reside here, and that the poorer a group is the greater is the exclusion. Further we know that high interest rates, patron-client relationships (bonds of loyalty or interdependence) and political and social networks rather clearly can reflect that moneylenders generally do not need, or wish to be, very competitive. This assumption can be underpinned with what Ray describes as 'interlinked credit transactions.' He writes:

A majority of village moneylenders do *not* pursue usury as their sole occupation. Most of them are also wealthy landlords, shopkeepers, or traders dealing in the marketing of crops. Given a segmented market, it probably won't come as a surprise to learn that landlords tend to give credit mostly to their tenants or farm workers, whereas traders favour lending to clients from whom they also purchase grain. Thus segmentation often takes place along occupational lines, and the complementary of some product relationship (tenant and landlord or farmer and trader) facilitate the credit relationship (Ray, 1998, p. 541, the author's emphasis).⁴⁶

4.5 Correcting for market failures in the formal economy

This part will discuss how the informal financial credit market in many cases substitute, and in other cases correct for market failures in the formal economy. Recognising that persons from all socioeconomic layers of the population participate in the informal commercial credit market, and that many act as both lenders and borrowers, this chapter will mainly focus on lending that is provided by more resourceful villagers and is directed towards resource wise inferior villagers (patrons providing loans to clients).⁴⁷ I have chosen to define the informal

⁴⁶ Ray describe a tendency towards segmentation in a credit market when many of the credit relationships are personalised, they have taken time to build up, and when it is common that the lender sticks to a fixed clientele whose members he lends to on a repeated basis (Ray, 1998, p. 540).

⁴⁷ The typical person who becomes a commercial money lender is often also a local patron. This means that he or she, it is mostly males that fits this description, is superior in terms of resources and power. Because of his

commercial moneylender (for which I use ‘informal lender’, ‘moneylender’ and ‘local lender’ etc. as synonyms in this text) as informal lenders of all types who provide credit (repeatedly if not as their primary occupation) with the expectation of benefiting financially from the loan.

In the former chapter we found that imperfect information and lack of collateral were the two of the main obstacles that hindered formal banks from directing services towards the poor. Local lenders have the advantage of information concerning the characteristics of clients relative to banks as they themselves live in the locality, they have networks of information flows and often guide clients in how to use the resources provided by them. Proper collateral can furthermore manifests in many more forms for a moneylender than for a bank.⁴⁸ A large landowner might see great value in a small plot of land bordering to his property, or he might require inexpensive/free labour on his farm or in the house. He therefore accepts a poor client putting up land or his own / his family’s services as collateral. The reasons why banks cannot, or often wish not to, accept labour or a small plot of land as collateral witness about an imperfect market of some kind. While there can be many answers as to why, the most obvious are that resale of labour powered by banks (as banks seldom need the services of unschooled poor) may be indistinguishable from slavery, and that resale of land may be constrained by informational problems in the proper identification of the owner or a buyer (Ray, 1998, p. 537).⁴⁹

The demand among low income households is typically for short term loans (often for working capital or to cover consumption needs, medical expenses, ceremonies and the like) that are made available quickly in convenient locations through easy processes (Robinson, 2001, p. 187), and that entail appropriate, thus often differing, repayment schedules

financial/political/religious/social position in the locality the patron will have less well-off villagers (clients) turning to him for assistance. This is not to say that the patron must be the wealthiest person in the village, but he tends at least to be financially independent and in a position to control and arrange his household’s resources. Moreover, he tends to be economical, or political (in the sense that he is in a position to for example gain control over government sponsored/subsidised goods that was meant for less fortunate villagers, or be in a position to influence village affairs and settle local quarrels) superior the majority of the people he provide resources to, though it happens that local patrons also borrow from their (resource wise) inferior clients. Personal characteristics such as persistence, ability to lead others, political interest, intelligence and ingenuity will furthermore contribute to determine who becomes a successful patron.

⁴⁸ Collateral in the informal sector can be thought of a something that express the intention of repaying. The value of collateral is determined by the notional value of the asset, not the expected sales value. A local lender can for example see great value in a relatively inexpensive ring which was given to a borrower by her bellowed grandmother, as it is very likely that the borrower will be under the lenders control until she can reclaim her ring. The formal bank, on the other hand, cannot sell the ring in case of default to regain the money lost, and it is therefore off no valuable to them.

⁴⁹ G. Milroy Paul, Director of Habitat for Humanity, expressed that the latter is a significant problem in relevance to Housing Microfinance in India, as he on more than two occasions during his presentation at the Annual Forum talked about how “clients seldom have clear legal land title ownership rights” (Jaipur, 22.06.2010.)

conditional to the borrower's cash flow. As we can read from the quote included in the former part discussing the banking system (and from the many that will follow in this thesis), the formal banks are not perceived to provide such services. There is little doubt though, that moneylenders provide such loans. However, there is considerable controversy about the interest rates associated with them. The alternatives in the informal sphere are typically diverse and often overlapping, but in the literature we mostly to meet three main views that aim to sum up moneylenders and their ways of conducting business. The arguments falls along a continuum of informal lenders, but we can broadly characterise them as follows; 'malicious and monopolistic', 'providing a much needed value for the people' and 'moneylending conducted under monopolistic competition' (Robinson, 2001, p. 177-185). There are two more categories of informal credit providers; one refers to assistance from/between relatives, neighbours and friends,⁵⁰ and the second to people who become lenders rather accidentally.⁵¹ My intention is to leave out the discussion of the latter two categories as they are less relevant for the discussion of whether or not there is a need for a different approach through which financial services should be provided.⁵² We will address the three main views because it is relevant to know them in order to understand the situations the range of people that meet their financial needs through the local lenders might be faced with. This chapter furthermore ends in a discussion of the factors that work against financial inclusion in the informal market.

⁵⁰ Robinson, referring to Carstens 1995, argues that such loans usually carry no, or sometimes low, financial interest, but that they may entail social, political and economical obligations ranging from providing free labour to committing reciprocal future loans, from providing information to rendering political support (Robinson, 2001, p. 173). If such low (if any) interest loans are based on reciprocity, a form of 'I help you out, expecting that you will help me out in the future' mentality works behind them, they might furthermore be thought of as a broader informal mutual insurance relationship. There are of course an opposite to the friendly neighbour argument as well, people taking advantage of their less fortunate family members or friends, but the main trend in the literature seems to be that friends and family are trying to help each other out.

⁵¹ An 'accidental moneylender' I would define as somebody that happens to have / come across surplus money and is surrounded by people he is 'obligated' or expected to share his (rise in) fortune with. Surplus money can come about by striking a good deal, or for example by experiencing a rise in income (though maybe only periodically) as children move out of the household, have finished their education and began to contribute to the households earnings, or parents die and the person inherit their resources. See Erik G. Jansen's *Competition for scarce resources*, 1986, p. 132-137, for an example of an accidental lender.

⁵² Such loans are relevant in the sense that they assist people who experience cash shortage, but because people rely on commercial informal lenders in addition to the loans made among neighbors, relatives and friends (a support which is likely to continue even if the clients borrow in the formal sector), it is the moneylenders we will focus on in this thesis. If people do not rely on additional services from commercial lenders, they are probably not in dire need a formal loan either, but it might nevertheless be beneficial. An accidental lender who becomes a full time lender will be addressed as a 'regular' lender in this thesis.

4.6 Moneylenders as malicious monopolistic agents

The people advocating moneylenders as ‘malicious’ argue that moneylenders conduct exploitive credit practices and charge exorbitant interest rates as a mean to make the borrower default so that the lender can seize the borrower’s assets, force him or her into bonded labour, extracting substantial profit, or gain the borrower’s produced goods at below market prices. The rationale behind why some view moneylenders as being exploitative is the fact that borrowers typically are poor persons with few other options through which to obtain capital, while the interest rates charged by the informal lenders typically are well above those found in the formal sector. The poor are furthermore seen as vulnerable persons that are driven to pay usurious rates out of desperation (Armendáriz de Aghion and Morduch, 2005, p. 27).

The fear for an informal credit market dominated by malicious lenders has not come about without a reason. Armendáriz de Aghion and Morduch (2005) recite Bhaduri (1973), who argues that: “By keeping farmers perpetually in debt, moneylenders strengthen their bargaining power in order to tighten the squeeze” (Armendáriz de Aghion and Morduch, 2005, p. 28). Robinson provides us with an example from her fieldwork in the Telengana region in Andhra Pradesh:

In this area, as in some other underdeveloped parts of India, a bonded labourer’s full-time work pays only the interest on the loan; it neither repays the loan principal nor provides subsistence. ... In most cases the labourer ends up having to reborrow from his lender or employer, perpetuating the bondage. The lenders only concern in such cases is to ensure that the labourer has enough food to be able to work. Some female bonded labourers are required to provide sexual services to the lender, in addition to their agricultural or domestic labour” (Robinson, 2001, p. 208).

Though there is no arguing whether exploitative moneylenders do exist, all informal lenders do not fall under this category.⁵³ The reason why some persons are allowed to conduct malicious practices, according to this view, is that clients are unable to substitute the lender’s services and must thereby accept whatever conditions / interest rates he demands. Furthermore “exploitation is possible since moneylenders have local monopoly power; that power is ‘protected’ because potential competitors lack the necessary information and connections to break into local markets” (Armendáriz de Aghion and Morduch, 2005, p. 28).

⁵³ I personally believe that the people who conduct malicious practices in many cases do so because of their nature. A person who begins with moneylending probably do not automatically start to speculate in bonded labour or land alienation if he is a good man with high moral standards and merely wish to make a profit from the interests or to help out a family member in distress.

4.7 Moneylenders providing a good value and much needed service for the people

The school of thought that developed primarily at the Agricultural Economics Department of Ohio State University in the early 1980s advocate that informal commercial moneylenders provide credit to low-income rural households at reasonable interest rates, as the interest rates required by them simply reflect the transaction cost and risk associated with lending to the poor (Robinson, 2001, p. 180-222). In some cases the cost associated with handling many small clients is high. The lender has to deal with clients who wish to borrow small amounts instantly, who lack a steady income flow and who do not have much savings (if any). They will therefore need individualised repayment schedules, and the possibility that they might have a hard time repaying is present. Due to the patron-client relationship it is furthermore common that borrowers repeatedly turn to the lender for assistance (in terms of acquiring advises concerning loan utilisation, to postpone repayment or to ask for some form of aid to cover the household's subsistence inevitabilities). The patron-client relationship is by no means merely a one way affiliation that enables a patron to extort clients; the clients are also able to take advantage of this bond as they can argue that 'their patron' is expected to help them out. Both the expectations to the lender and his dealing with many and diverse clients can contribute to high transaction costs and a high degree of risk.

On the other hand, the lender has a network that can provide information about potential borrowers, and as he tends to stick to a limited clientele he already knows most of the people he lends to. He often lives and works in the locality, so checking up on the clients should be fairly easily obtainable at a low cost. The lender is in a position to exert much pressure on a borrower to repay since the client is likely to be more dependent on the goodwill of the patron than what the patron is on that particular poor villager, and the lender might be associated with other influential villagers, lawyers or government officials that will allow him to push certain borders when redeeming money. Viewed from this angel there is thus little to support the argument of a high degree of risk, and it suggests that the transaction costs might not be unreasonable high.

Moneylenders manage risk in a number of ways, but what appears to be a general trend in the data Robinson (2001) provides, is that the interest rate vary with the degree of poverty a person live in and the size of the loan. "[T]he poor are charged higher interest rates because they have low bargaining power, and because the transaction costs to lenders in making small loans are essentially the same as those in making larger loans. If interest rates were the same, smaller loans would be less profitable" (Robinson, 2001, p.198).

4.8 Monopolistic competition sets the boundaries for informal lending

Why can we argue that moneylenders are experiencing to conduct business under the regulations of monopolistic competition? Stiglitz provides us with a definition of what monopolistic competition is. He begins by explaining that when a single firm supplies the market, economists refer to it as a ‘monopoly’ and when a few firms supply the market, we have an ‘oligopoly’. From there he continues:

And even when there are many firms, each may produce a slightly different good and may thus perceive itself facing a downward-sloping demand curve. Economists refer to such situations as **monopolistic competition**. In all of these situations competition deviates from the ideal of perfect competition, where each firm is so small that it believes there it is nothing it can do to affect the prices (Stiglitz, 2000, p. 77-78, the author’s emphasis).

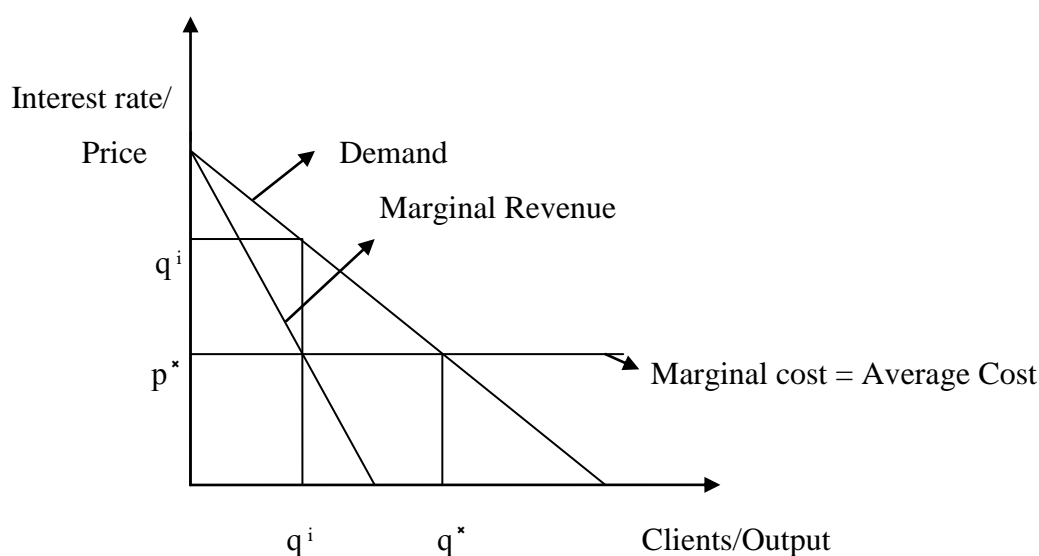


Figure 4.8.1, Monopoly pricing⁵⁴

As we are talking about moneylenders, the figure cannot be applied as a textbook model, but it does give us an idea about how the market works.⁵⁵ What we can read from the figure is that the downward-sloping demand curve gives room for the lender to alter his interest rates

⁵⁴ The figure is based on a figure presented by Stiglitz, 2000, p. 79.

⁵⁵ In a market characterised by free competition, the moneylender would have to set his interest rate at p^* where marginal cost (MC) = demand (D). This means that if the moneylender sets his interest rate higher than p^* , the clients would have turned elsewhere because his product could be substituted, or found, in another location at a lower price. In situations with monopoly pricing the level of outcome, or the number of clients (q^i), is lower than the competitive output (q^*). Strictly theoretically, perfect competition means that a firm sets the extra gain it receives from selling one more unit of output, the marginal revenue, equal to the marginal cost to maximise its income. That the demand curve has a downward-sloping shape translate into that the firm will have to lower its price on the extra unit it wants to sell, and therefore also on all the previous units (as price discrimination is not an option).

without losing all his clients. As the moneylender tends to be a powerful villager he might furthermore be in a position to price discriminate which regular firms are not. This means that he does not have to lower his prices for all just because he provides some with a loan at a lower rate of interest. The other distinction we have to remember is that the lender might face some competition because the village economy is not necessarily characterised by his monopoly, ergo monopolistic competition. The lender might therefore have to offer his clients something extra, additional services, to keep them from shopping around for credit.

Robinson argues that the large number of lenders in these markets can give the illusion of competition, but that the new entrants normally do not compete for the borrowers of established lenders due to the interlinked transactions and their entrance do therefore not tend to drive interest rates down (Robinson, 2001, p. 182-183). “Those who want to expand their lending typically do so through credit layering: providing credit to linked borrowers who tend to onlend to their own interlinked borrowers. ... Having no incentive to do otherwise, moneylenders maintain high interest rates and ration credit” (Robinson, 2001, p. 183). Monopolistic competition, her model of it,⁵⁶ does certainly contribute to explain differing interest rates between informal lenders, but I wish to point out that anecdotal evidence imply that “money lender’s interest rates have declined in areas where SHGs and MFIs have become operational” (Srinivasan, 2008, p. 88).⁵⁷ This suggests that microfinance is in a position to challenge informal lenders relative monopoly, which, even if informal lenders continue to prosper, perhaps can contribute to lower excessive interest rates in the informal sector.

4.9 Concluding remarks

So far we have found that it appears to be a mismatch between the services provided by formal banks and the financial requirements of the poor as the banking sector shows signs of rather considerable financial exclusion of low-income rural residents. We have documented that informal lenders might be better able to meet the genuine credit needs of the poor as local

⁵⁶ Robinson argues that her variant of monopolistic competition differs from the classic model in two closely related ways. Firstly, entry to the market is free, but only to a certain point. New lenders can enter the market freely as long as they do not lend to borrowers that are already served by other moneylenders in the area. Secondly and directly related, long term profit is possible to obtain, which she argues it not the case in the classic monopolistic competition model (Robinson, 2001, p. 182-183).

⁵⁷ In an attempt to find out more about this I sent an e-mail to Mr. Srinivasan and asked whether he knew of any studies undertaken on this matter since, proving a link between lowered interest rates in the informal sector and microfinance. I have extracted a part of his reply: “There have been a few studies which indicate that money lender's interest rates have declined. I am unable to give you the references offhand as I am in Ethiopia now on a mission. But you will find references in this year's State of the Sector report 2010 which will be released on 15 November 2010” (24.09.2010). The 15th is unfortunately also the deadline for this thesis, but please see the report for further reading on the subject.

lenders timely provide a more flexible range of (credit) products, and we found that the informal lenders often are more willing to serve poor people as they are better equipped to gather information about the borrowers, and that they can accept collateral in forms which the formal banks cannot. Nevertheless, we also found that informal lenders tend to stick to a limited clientele of people whom they usually interact and trade with in other markets, and that this can have an excluding force on potential borrowers who are outside the local lender's (preferred) network. We have documented that local moneylenders often experience to conduct their business in a relatively monopolistic manner, which may result in excessive interest rates, credit rationing, exploitation in terms of providing loans to seize other people's assets or to secure bonded labour and (social) humiliation of the borrower and/or his household members. As the dealings in the informal sector grants local lenders relative monopoly power which we saw other informal lenders have a hard time to challenge, formal providers of finance might be the only ones who can enter the market and perhaps infuse competition in the sector. These findings post a strong need and an ample space for innovative approaches through which one can serve the financial needs of the rural poor through the formal sector.

What shape has the microfinance movement in India taken, and how does it aim to correct for market failures in the formal economy?

Microfinance in India is primarily provided through two approaches, the Self Help Group-Bank Linkage Programme (SBLP) and the Microfinance Institutions (MFIs). In the SBLP the Reserve Bank of India (RBI) and National Bank for Agriculture and Rural Development (NABARD) are promoting relationship banking, i.e. improving existing relationships between banks and the poor through social intermediation of NGOs (non-governmental organisations). In India the SBLP is the approach which has been able to reach the most clients. In addition to this, we find the microfinance institutions (MFIs).⁵⁸ The expansion of the MFI approach in terms of client acquisition was initially off to a slower start than the SBLP, but in the last years it has gained pace and it can seem like the MFIs might catch up to the SBLP within long.

One cannot consider the MFI approach and the SBLP approach to be two different movements; rather one can regard the whole movement to be made up by two facets. According to Dr. Navin Anand,⁵⁹ one is the socially oriented approach adopting the self help group model which is looking for social, economic and political empowerment of women as an end.⁶⁰ The second facet is a pure microfinance approach wherein the microfinance institutions see providing microfinance as an end. These MFIs are also concerned about

⁵⁸ The range of providers of microfinance can broadly be categorised as ‘formal institutions’ and ‘semi-formal institutions’. According to Rao: “The former category comprises apex development institutions, commercial banks, regional rural banks, and cooperative banks that provide microfinance services in addition to their general banking activities and are referred to as microfinance service providers [the microfinance service providers are associated with India’s SBLP]. On the other hand, semi-formal institutions that undertake microfinance as their main activity are generally referred to as microfinance institutions (MFIs)” (Rao, 2008, p. 57). At several points in this thesis I will address the microfinance sector in general, thereby not differentiating between the formal and the semi-formal institutions, the MFI approach and the self help group-bank linkage programme. In such cases I have chosen to disregard this difference in terminology and refer to both categories as ‘providers of microfinance’ or ‘formal institutions providing finance’.

⁵⁹ Dr. Navin Anand is the Resource Person and Moderator for the Microfinance Community, Solution Exchange, working at the United Nations Development Programme (UNDP) office in New Delhi. This information was expressed by e-mail, 12.01.2010.

⁶⁰ This incorporates various initiatives of ministries like Rural Development, Social and Economic Justice, Department of Women and Child Development, Ministry of Human Resource Development (Department of School Education and Literacy and Department of Higher Education), Department of Cooperation, Ministry of Agriculture; National Bank for Agricultural and Rural Development/Reserve Bank of India, and projects initiated by Non-Governmental Organisations and/or International Agencies.

socioeconomic development of poor, but do not necessarily undertake the responsibility of taking it up as a key agenda.

This chapter will examine in what ways microfinance is expected to tackle the market failures we found to be present in the formal economy in order to reach the poor and to improve the formal sectors competitiveness relative to informal lenders. We will first take a brief look at the history of microfinance as well as the two approaches, before we proceed to explore in what ways the mere workings of microfinance is expected to correct for poor borrowers lack of collateral and the imperfect information that causes adverse selection and moral hazard. To do this we will rely on the relevant algebra that we have explored in chapter three and four (which can be found in Debraj Ray's *Development Economics* (1998) and Armendáriz de Aghion and Morduch's *The Economics of Microfinance* (2005)).

5.1 The origin of microfinance

As an attempt to reach the poor clients that are served badly, or maybe not at all by regulated financial institutions and the informal financial service of moneylenders (neighbours, relatives and friends), the notion of microcredit was born (the origins of microcredit in its current form is generally traced to the mid-1970s when Professor Yunus started the first Grameen Bank⁶¹). Microcredit is the provision of very small loans that essentially is used by low income households with few assets that can be posted as collateral. The loans are repaid in small weekly, biweekly or monthly amounts, and the entire loan is usually repaid within a short period of time.

Gradually, a paradigm shift took place- from the delivery of government- or donor-subsidized credit to the development of sustainable financial intermediaries that capture local savings, access commercial finance, and lend these funds to low-income borrowers at interest rates that enable full cost recovery and institutional self-sufficiency” (Robinson, 2001, p. xxxii).⁶²

The microcredit industry had begun to recognise that the poor required a variety of financial products besides credit to meet their needs, and the concept of microcredit evolved into

⁶¹ Though Mohammad Yunus is often recognized as the initiator of microcredit, others similar initiatives originated in the 1960s and 1970s. Self Employed Women's Association (SEWA) established SEWA Bank in India in 1974 (SEWA, 2009a, [online]), and according to ACCION's webpage ACCION International begun as a student-run volunteer effort in the shantytowns of Caracas, Venezuela, it was founded in 1961 and has been a leader in microfinance since 1973 (ACCION, 2007a, [online]; ACCION, 2007b, [online]). “Acción International launched the first micro-credit organization in Recife, Brazil, although several others followed, such as *Bank Rakyat* in Indonesia and *BancoSol* in Bolivia. The Grameen Bank in Bangladesh is only one of these initiatives” ((the author's emphasis) Sola, 2007, [online]).

⁶² According to Robinson this “microfinance revolution” first occurred in Indonesia in the 1980 and then in Bolivia in the mid-1990s (Robinson, 2001, p. xxxii).

microfinance. Microfinance tends to be a ‘savings first approach’ which typically involves the provision of thrift, credit and other finance services such as money transfer and microinsurance products of very small amounts to the poor, with the aim to raise income levels and improve living standards. As a solution to the lack of appropriate collateral, and to correct for imperfect information about borrowers, microfinance rest on collective security as a means to secure loan repayment through social sanctions and peer enforcement.

5.2 The self help group-bank linkage approach

As a response to the discussion ‘A National Regulatory Framework for Microfinance Sector’, that is currently running in the Solution Exchange Microfinance Community,⁶³ Mr. A. P. Fernandez, former Director of Myrada and presently the Chairperson of NABARD Financial Service Limited (NABFINS), shared his article *Is Micro Finance leading to a Macro Mess - the AP Ordinance* on November 9th 2010. The following is an extract from the article and shows the origin of the self help group-bank linkage programme (SBLP):

To explain this a little further, we need to briefly trace the history and the concept of what a real SHG is. This history has been buried under media coverage promoting the fast growing Neo-NBFC model. Between 1984-1986 Myrada (an NGO) worked with the primary Cooperative Societies as the base institution. It realised that far from fostering the interest of all, the benefits went to a few powerful families including the President, Secretary and a few others. They borrowed at the official rates (6% - 8%) and on lent to others at rates ranging from 30% to 40%. The poor were dependent on the powerful for jobs, immediate loans etc. Myrada encouraged them to challenge this situation. They broke away and formed small groups - the members were self selected; we later realised that the groups were based on affinity among the members. Affinity in turn was based on relations of trust and mutual support which existed before we entered. This was later called social capital and was the strength of people on which Myrada built. After several rounds of discussions they decided to return the loans they had taken from the Cooperative to their respective group. Myrada encouraged them to meet weekly; each member contributed to the agenda which comprised issues related to health, domestic problems, need for credit etc. They were encouraged to save and Myrada staff kept records of meetings and accounts. When they wanted money, they were encouraged to take loans from their savings which meanwhile had been deposited in a local Bank. These groups were the real cooperatives. Myrada approached NABARD in 1986 with a request to support this complimentary/alternate mode (Fernandez, 2010, [online]).

Finding the formal financial system inadequate to cater to the financial needs of the rural poor, NABARD decided to engage in the project with MYRADA in 1987. Their aim was to combine the safety and reliability of the large network of formal finance that exist in India with the convenience and flexibility that is associated with informal finance. MYRADA was to form affinity or ‘saving and credit’ groups (later renamed ‘self help groups’) that after extensive training would be linked to the formal banks. The success of this field level

⁶³ An email based community in which practitioners, scholars and others can raise concerns and share knowledge and experiences in regards to the microfinance sector.

experiment encouraged NABARD to launch a pilot project in 1991-1992, and steady progress of the project resulted in the mainstreaming of the SBLP in 1996.

To correct for the shortcomings in the formal economy providers of microfinance use collective security / social capital as a means to secure loan repayment through social sanctions and peer-enforcement. This goes for banks and for most MFIs, though MFIs also rely on joint liability groups which will be discussed shortly. Each promoting/providing organisation/institution has its own procedures and requirements, but a tendency is that clients themselves form groups made up by five to twenty people who must agree to co-guarantee for a loan taken by anyone in the group.⁶⁴ The group meets on a regular basis, usually once a week, biweekly or monthly, together with a staff member from the respective institution or organisation to collect and/or deposit money. The staff member is expected to provide the clients with some basic training in how to handle money (increase financial literacy, and in some cases literacy in itself), he or she is to raise health awareness, to teach human rights, and to instruct the clients in how to deal with social issues such as early marriage, polygamy, divorce and dowry (Kabeer, 2005, p. 100-102; Aminur Rashid, 1997, p. 201).

After six months of being in a group, pooling their savings, receiving appropriate training and inter-loaning from their common basket of resources, the SBLP requires that the group goes through a grading. The group's activities are reviewed by a committee (made up by bankers, NGO staff, a grading agency or others) that decides whether or not the group is prepared to handle the responsibility that comes with having relatively easy access to rather large amounts of money from the formal banks. The first grading, though the processes might differ depending on the people in charge of making the decision, will usually be an

⁶⁴ It is mostly women that are microfinance clients. From a developmental perspective the main arguments to focus on women is that at any level of poverty, women tend to be the poorest, and girls are typically the most deprived (Robinson, 2001, p. 8). Furthermore it is argued that a destitute mother is more likely than her husband to spend income on the welfare of her family (Fisher and Sriram, 2002, p. 130; Greeley, 2005, p. 25), and that she will prioritise to create a safe and healthy environment for her children by spending more on consumption goods, household articles and education. Her contribution to the household might gain her more respect within the family unit, which has proven to give greater power in renegotiating daily chores and greater influence in household's decision-making processes (Kabeer, 2005, p. 87; Fisher and Sriram, 2002, p. 128-129). Kabeer further documents that clients of MFIs are more likely than non-members to vote at local level elections, to participate in election campaigns and to express a desire to contest at local elections (2005, p. 118-119).

Morgan Brigg, on the other hand, refer to Rahman who has argued that even though the official line is that targeting women brings about faster improvements in family conditions and solidarity for women, the actual reason for excluding men has much to do with the ease in disciplining the different genders. Rahman found that (Grameen) bank workers regarded men as arrogant and difficult to deal with. He claimed that Grameen staff preferred to focus on women as they tended to be shy, passive and submissive, and because they were easily traceable in the village because of their constrained mobility (Brigg, 2006, p. 80)

assessment of the creditworthiness the group.⁶⁵ If the committee decides that the SHG is ready to graduate, the group's savings is placed in a group deposit account in the name of the group at the bank before the members can begin to borrow. SHGs usually borrow at about 12 per cent per annum, plus an additional interest charge decided on by the group which goes to the groups pooled resources (Basu and Srivasatava, 2005, p. 11). Banks typically provide the group a loan amounting up to four times the group's savings, and the group will distribute the amount borrowed amongst them as they find it to be fit. The SHG funds may be distributed either to one or more members of the group who are personally responsible for repayment to the group, or spent collectively by the group. The group's funds are rotated through lending within the group, but the SHG as a unit is responsible for repaying the bank. Thus, the group members save, borrow and repay collectively, which gives them the advantage of lowered transaction costs in dealing with the banking bureaucracy, and access to (larger) amounts of formal credit despite the fact that they (usually) lack material collateral. According to the Report of the Committee on Financial Inclusion the "SHG – Bank Linkage Programme can be regarded as the most potent initiative since Independence for delivering financial services to the poor in a sustainable manner" (C. Rangarajan, 2008, p. iv, [online]).

5.3 Microfinance institutions

Scholars trace the microfinance initiative in India back to the undertakings of Ela Bhatt and her efforts to provide financial services to poor women working in the unorganised sector in Ahmedabad. Bhatt contributed to found the Self Employed Women's Association (SEWA) in December 1971, which registered as a Trade Union in 1972, and in 1974 SEWA established its own bank (SEWA, 2009a, [online]; SEWA, 2009b [online]). Microfinance Institutions (MFIs) can broadly be defined as "institutions other than banks that are engaged in provision of financial services to the poor" (Jindal, 2008, p. 69). This very broad definition includes a wide range of providers that vary in their legal structure, mission, and methodology. However, according to the Consultative Group to Assist the Poor (CGAP) they all share the common characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank client (CGAP, 2010, [online]). The MFIs that operate in India today can be broadly sub-divided into four categories of organisational forms; NGO-MFIs,

⁶⁵ To assess this, the committee tends to look into group dynamics such as the participation of members, why the people have come together, cohesion in the group, the record keeping of the group, goal-oriented action undertaken/planned by the group, democracy in decision making and collective leadership within the group. They will decide whether the group is functioning as it should, how the group's saving and repayment discipline is and whether the group is sustainable or not.

Non-Profit Section 25 Non-Banking Financial Companies-MFIs, (Mutual Benefit) cooperative MFIs and For-Profit Non-Banking Financial Companies-MFIs (K. Muralidhara Rao, 2008, p. 59-61).⁶⁶ Some MFIs provide loans through SHGs in the same way as described above (except for the processes of bank linkage), some provide individual loans, and the most recent model adopted by Indian MFIs is that of Joint Liability Groups (JLGs). In the Intellect White Paper “Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?” it is stated that:

Unlike the SHG model wherein the loan is given to the group and the bank does not track individuals’ credit history, in the Grameen-inspired JLG model the loan is given to the individual (usually by the MFI), backed by the group guarantee; and an individual credit history is created, even though it may be skewed by the group guarantee scheme (2010, p. 1 [online]).

A. P. Fernandez argues that:

They have instead formed Joint Liability Groups (JLGs) which experience has shown are neither joint or mutually liable or groups. Several policy makers in Government have supported the JLGs in preference to the SHGs since, the evidence shows, the JLGs are by far the quickest and cheapest way of disbursing credit. The SHGs require investment in institutional capacity building - which NABARD has supported since 1992; but it takes time - at least 6-10 months during which savings are promoted and internal lending starts before the Banks advance a loan. But today the name SHGs is a veil used by the neo NBFCs that covers (and justifies) many animals (Fernandez, 2010, [online]).

5.4 To tackle market imperfections through a group lending approach

It is by providing financial services to the poor through a group lending approach that practitioners of microfinance expect to correct for the imperfect information that banks used to experience about borrowers and the clients’ lack of proper collateral. The advantage of group lending is, on the lender’s part, that he can transfer the job of screening potential borrowers, monitoring their efforts and enforcing contracts onto the clients. For the borrowers group lending means that they access loans that otherwise would have been inaccessible, or at least not been available at such low rates of interest (Armendáriz de Aghion and Morduch, 2005, p. 113-114). Below we will explore in what ways the group lending approach is expected to correct for adverse selection and moral hazard. From there we continue to take a closer look at the benefits as well as the costs of having to attend group meetings, and on how the requirement of group lending might contribute to exclude poor people from accessing microfinance. Rounding off this chapter I will sum up what we have addressed which will

⁶⁶ Due to the scope of this thesis and the little relevance the different categories of MFIs have for this thesis, I will not discuss them further here, but I do recommend Muralidhara Rao’s “*MFIs in India: An Overview*,” p. 59-62, and Krishan Jindal’s “*Regulatory Framework from MFIs*,” p. 69-78, for further reading on the subject. Both articles can be found in “*Microfinance in India*,” edited by K.G. Karmakar, 2008.

help us determine to what extent the group lending approach actually corrects for market failures in the formal economy.

5.5 Tackling the problem of adverse selection

Recall from chapter three that the problem of adverse selection occurs when lenders cannot distinguish inherently risky borrowers from safer borrowers. The lender is forced to charge all clients higher rates of interest in order to compensate for the possible default of unsafe borrowers. “The inefficiency arises when this implicit subsidy is so large that safe borrowers leave the market rather than shouldering the burden - namely, when the presence of risky borrowers raises the interest rate to levels that are simply unaffordable for safer borrowers” (Armendáriz de Aghion and Morduch, 2005, p. 89). Promoters of microfinance believe that lending to groups with joint responsibility might mitigate this inefficiency.

A common feature of SHGs is that the group members themselves decide who they wish to make partners. All members know before signing up that in the event of default no one in the group is allowed to borrow again. This provides the incentive to form a group with much caution so as to weed out the borrower who could jeopardise the creditworthiness of the group as a whole. The potential borrowers will, for their own good, make use of all the information available to them about their fellow villagers to find the people who are less likely to default. As the clients are faced with the prospect of joint responsibility for a loan, it is clearly better for safer customers to stick together, “... this induces a form of *self-selection* that no individual-based banking scheme can mimic” (Ray, 1998, p. 579, the author’s emphasis). According to Armendáriz de Aghion and Morduch this practice, given that the safe borrowers actually can choose, leaves the less safe borrowers no choice but to form groups with other risky types (Armendáriz de Aghion and Morduch, 2005, p. 89). Ray argues that group formation has the property to drive risky types out of the market, seeing that their riskiness now is born by other borrowers instead of by the bank alone (Ray, 1998, p. 580).

Believing that the government targeting to reach priority sector poor somewhat counter that risky borrowers get pushed out of the market, how than will group formation benefit the lender and the safer clients? Ultimately, this boils down to that risk is transferred from the bank onto the riskier borrowers, and that, effectively, safer clients pay lower interest than their counterparts as they no longer have to cross-subsidise the riskier clients. The only persons who have to repay for a default loan is the defaulter’s group members, and it is believed that they will strive to do so in fear of being denied future access to financial

services. The bank does not necessarily obtain more information about who the risky customers are through the group lending approach, but it can take advantage of the fact that the group members themselves might have good information about fellow members and therefore rely on that the joint liability gives the members incentives to use their information to the bank's advantage. "Strikingly, the result is that group lending methodology does the trick even though (1) the bank remains as ignorant as ever about who is safe and who is risky, and (2) all customers are offered exactly the same contract" (Armendáriz de Aghion and Morduch, 2005, p. 90).

Karmakar, on the other hand, notes that most groups neither are formed naturally nor voluntary, but that people come together in need (Karmakar, 2008, p. 50). This might affect the natural selection referred to above, but as shown by Armendáriz de Aghion and Morduch (2005, p. 94-96), this should not raise the interest rates charged by the bank to such a level that it will drive the safer customers out of the market.⁶⁷ Their analysis show that regardless of whether risky and safe customers happens to be in the same group, all customers should be interested in borrowing at the going (cost covering) rate charged by the bank. "The bottom line is quite surprising: in principle, the group-lending contract can help lenders reduce interest rates- even where neither the bank nor the client have information about who is safe or risky! In the process, adverse selection can be mitigated and greater number of worthy borrowers can get access to credit" (Armendáriz de Aghion and Morduch, 2005, p. 96).

Group lending thus, has two effects for the borrower which cuts in opposite directions. "First, relative to individual borrowing, it *increases* the risk on any one borrower for a *given* level of project riskiness: this is a cost. Second, it creates pressure for peer monitoring to lower the level of project riskiness: this is a gain" (Ray, 1998, p. 580, the author's emphasis). According to Stiglitz (1990), under some conditions, the gain from such procedures outweighs the loss and leads to better overall institution (Stiglitz referred to by Ray, 1998, p. 580).

Because banks taking advantage of the group lending methodology should be better insured against defaults, average interest rates for both risky and safe types can be reduced (or be kept low despite information asymmetry) while the banks still makes a profit (Armendáriz de Aghion and Morduch, 2005, p. 90). As an additional force working to encourage banks to

⁶⁷ Their analysis merely aims at showing the potential for gains as it draws on specific assumptions about the nature of risk and the role of limited liability. Furthermore it assumes that groups are made up by two persons who borrow at the same time. We know that groups can be made up by somewhere around 5-20 persons who all pool their savings, and that all the clients seldom borrow simultaneously. This means that there is more than one member who can compensate for a defaulter (i.e. less amount per person), and that sequential lending hinders that all borrowers should default simultaneously. This just post an even stronger argument that group lending in fact can tackle adverse selection.

lend to the poor is that NABARD refinance loans made to SHGs at a subsidised rate. The banker I met with in Uttarakhand summarised the scenario the State Bank of India branch he worked in was faced with in the following way:

SHGs are always welcome, no much rules are there. Only minimum rules; they should be combined for six months only and have had the first grading, they should be holding the meetings every month, they are doing some sort of activity. That's all, then we are providing them finance. We have provided it to so many groups. It is no denying of finance to SHG because all money we are getting refinanced by NABARD, so it is always a profitable venture, we are not losing anything. We are able to finance the SHGs, we are able to get the money whatever we finance and we are able to get the interest difference. That is our profit.⁶⁸

Providing microfinance through a group lending approach should both encourage banks to lend to the poor, and it should encourage the safe customers, who no longer have to cross subsidise the more risky, to re-enter the market.

5.6 Mitigating moral hazard

Let us recall the problem of moral hazard addressed in both the previous chapters; once a loan has been made, the lender might face the risk of strategic default due to difficulties in monitoring the borrower's actions. The borrower might not put in the required work to succeed, or she can pocket the money and run after profits have been realised. Group lending with joint responsibility is argued to circumvent the moral hazard problems since the group members, who often live and work closely together, is expected to impose social or economic sanctions on each other. Social sanctions typically involves excluding 'problem' borrowers from privileged access to input supplies, from further trade credit, from social and religious events, or from day-to-day courtesies (Armendáriz de Aghion and Morduch, 2005, p. 109). Such measures of monitoring each others' actions and inflicting penalties upon those who do not put in the required effort, thus burden the group with excessive risk, might be impossible for an outside bank to match (Armendáriz de Aghion and Morduch, 2005, p. 96-97).

Although joint responsibility can be a door opener for poor people who are excluded from formal financial services, it does not automatically translate into peer pressure and repayment. Kabeer reports that even though the pressure exerted on those who did not come up with their weekly repayment was strong, the support for tactics such as penalties, persuasion by staff, pressure to leave the group or reconsideration of loan terms in reclaiming borrowed assets was very low (Kabeer, 2005, p. 104-106). Milgram, who has studied

⁶⁸ Uttarakhand, 26.09.2009.

microfinance in the Philippines but whose data still finds relevance in this thesis, shows that even the tactic of peer pressure can fall short when a client finds herself bound to divert her loan to cover essential family needs instead of spending it to earn an income. The other group members, understanding the rationale for the defaulters prioritising, may choose not to exert the pressure that the MFI expects because they know that they would have acted in the same way if they were in the defaulter's situation (Milgram, 2006, p. 177). As the client is most likely forced to default due to circumstances beyond her control, this is not a case of moral hazard. However, it brings about one very important point; a genuine financial difficulty that results in an involuntary default might actualise unwillingness to repay (strategic default) from the rest of the group. If more than one person in a group has taken a loan, and somebody defaults, the rest of the group automatically lose their right to future credit unless they can cover for the defaulter. Because the group's credit rating is destroyed anyway, the group members experience little incentive to repay (imposed by themselves at least), and might strategically default and pocket outstanding debt (Ray, 1998, p. 580, referring to Besley and Coate, 1995). As the women themselves distribute the formal borrowing under the SBLP, these groups might be more exposed to such a threat (in absence of regulations on how many that can borrow at the same time), than SHGs for whom sequential lending is a requirement. Given sequential borrowing the defaulter might still spoil the other members' chance of obtaining future credit (when no considerations are taken and the lender does not satisfy with disclaiming the one who did not repay), but it will not lead to strategic default by the others as they have not yet received loans.

The mutual coverage for defaulters has been documented to lead to considerable resentment on the part of the clients themselves, and their spouses (Kabeer, 2005, p. 106). Data collected in India, Nepal and Bangladesh all express that hostility and coercion that hinder group unity might arrive when members vigorously monitor each other's consumption and repayment patterns (Rankin, 2006, p. 194). Fernando shows that a group leader, in consultation with a field-officer (MFI staff), can intervene to such a degree that she plays an important role in regulating the entire consumption of a family as well as their social expenditures (Fernando, 2006b, p. 218). The latter implies that group pressure is applied on the entire family, and such interference may in turn cause conflicts between, and within, households.

Monitoring each other and being risk averse might furthermore be costly. A cost that is likely to increase if the borrowers do not live and hold their meetings in close proximity. In

cases where the travel to check up on the other members are time consuming and relatively expensive, monitoring might be imperfect and the door is once again opened for moral hazard to enter back into the picture. “Why should I work hard if I am liable for penalty when my partner shirks- even when I cannot control their action?” (Armendáriz de Aghion and Morduch, 2005, p. 87). What is changed in such scenarios relative to individual lending though, is that the borrowers now carry the risk of a group member defaulting. The provider is more likely to receive full repayment as the group will have to cover for the defaulter in order to access future services, and because it holds the group’s pooled savings.⁶⁹

5.7 The self help group meetings

SHGs usually meet regularly together with a representative of the associated NGO, MFI or bank to carry out their transactions. These meetings have some obvious and simple advantages both for the lender and for the borrowers. The most prominent advantage of group meetings for the borrowers is that the bank comes to them, whilst for the lender it is that he can handle multiple small sized savings and loan transactions in a relatively short period of time, as he is only faced with a single deposit and a single withdrawal per group.

The argument that lending through a group approach is not time consuming is challenged for a number of reasons. First of all it is common to meet stories in the scholarship on the subject which tells of microfinance lenders that do not leave the village, the home of a defaulter, or finish off a meeting until all clients have deposited the correct amount (or it has been done on their behalf). Second of all, the travel back and forth to group meetings can impose a rather substantial cost on both the lender and the borrower, especially in areas with low population density or harsh geographical conditions. Consider for example this statement by Father Francis who is now working with SHGs in the Chamoli district of Uttaranchal.

After coming here, in a way, I was a bit discouraged also. As we do in the plains, it is very, very difficult to do in the hills. If you are in the plains you can visit that district, maybe five-six villages you can cover. You can see our animators [staff in charge of forming, training and handling the SHGs and

⁶⁹ In this respect one should note that peer pressure is not the only way to secure repayment by providers of microfinance. Fernando reports that a staff-member might threaten a potential loan default with a law suit or an arrest, and he can, with the help of a government official, threaten to withhold whatever government assistance that is available to the client. The poor respond to these threats because they fear that they will have to mortgage the house or their land, which in turn can lead to the loss of these properties, in order to raise the funds needed to cover potential legal fees or bribes to the local government officials or policemen (Fernando, 2006:211). Others mention stories of “forced” acquisition of household utensils, livestock or other assets of defaulting members (Montgomery referred to by Armendáriz de Aghion and Morduch, 2005, 100). The fear of peer pressure and threats made by staff can, together with the risk of co-guaranteeing for others’ loans, have an excluding effect on people, especially on those who hold the financially weakest positions in the community.

their requests] they are working, and you can evaluate. We can also make sure that they are visiting the villages and conducting their meetings. It is very, very easy. But after coming here, once you go to one village, you come back, that is the end of the day. Because you reach there, it takes nearly two hours, than from there is a two hour climb to reach top hill. Then, after reaching there, you have to find the people and bring them from the fields, *than* you can make the meeting.⁷⁰

What we can read from the Father's statement is that it is very unlikely that the associated women would be included in the formal financial sector if his (or another) NGO had not been working in the area. The distance from the clients' village to the nearest bank branch (which was in the town Father Francis and I met) is, as stated above, a travel that takes about four hours each way. For this reason alone, it is fairly safe to assume that many of the associated clients would rather borrow from an informal source in need of cash than to lose workdays, or spend (in relation to their income) a substantial amount of money on repeatedly having to travel back and forth into town in their *attempt to obtain* a formal loan. By bringing the bank to the women, the lender/facilitator thus offers the same convenience as local moneylenders, but at better terms. The clients access credit, a safe place to save and the interest rates in the formal sector are (assumably) less than what they are in the informal sector, and as we in the example above refer to groups that are part of the SBLP, the bank's interest rates are regulated with a interest ceiling on 12 per cent per annum (plus the additional two per cent that the women have decided and imposed on themselves, resulting in an annual 24 per cent). In this case the group lending approach lower the transaction cost associated with formal finance for the clients, but the cost to the bank/facilitator is proportionally higher. When NGOs take on the responsibility of forming and grooming groups nevertheless, the bank will not be affected by this in the way that it would have been if it was to promote its own groups (if the bank was an MFI). The adoption of the Banking Correspondent (BC) and the Banking Facilitator (BF) model finds its relevance in enabling banks to reach poor clients more cost efficiently in areas like this; characterized by poor infrastructure, relatively low population density, low levels of literacy and a relatively undiversified economy.

The cost of transportation to the meetings is not always born by the financial institution alone. Often, especially in remote areas, the clients have to travel a bit to reach the meeting place. Together with the opportunity cost of attendance (i.e. lost income due to time away from paid labour or less time to perform ones obligation in the household) this requirement can present a barrier for people to participate in SHGs. From what I learnt during

⁷⁰ Uttarakhand, 26.09.2009.

the fieldworks the question of an opportunity cost introduces two issues I wish to address.⁷¹ First of all, for it to present a barrier we must assume that attending a meeting comprise of time away from paid labour, and second of all, that people attends the meetings themselves.

The problem with the first assumption is that it takes for granted that people actually work every day, or at least often enough to make attending group meetings a liability. In Uttarakhand I discussed rural employment with the NGO manager, Mr. Dayaram.⁷² He explained that villagers in theory were guaranteed 100 days of employment through the government scheme NREGA, but that through his work he had become aware that the villagers in the area seldom accessed this.⁷³

Government is corrupt in its policies, each and every policy. ... So many holes, just like the NREGA. Villagers never, so many villagers get only ten days. So this is very poor, the Act status is very bad, program status. ... Implementation is this; all families have job cards, certificate for working. They demand for work, and within 14 days they get work, and within 15 days they get money. ... BC [Block Development Coordinator/Block Development Official (BDO)] do this, clarify this work. But if any job-card person was in writing to say that "I want to work" to Block Coordinator, he never received this. They don't receive this thing, because if they receive this thing, within 14 days, compulsory get me job. But they have not money. (Monica: They say they have no money? But the government has provided the money?) Has given the money. Government send to CDO, chief development official, district level, and district level official send this money at block level, after demanding the work, after processing the work, the BDO, block level official, gives this money in Panchayat. This is the process. But government not processed this money in time, they say.

According to Mr. Dayaram both the district level officials, block level officials and the village Panchayat was scheming of the funds made available by the government for implementing NREGA. This resulted, according to him, in that the unemployed villagers did not receive the employment they were entitled to and thereby seldom earned the 10 000 Rupees yearly which NREGA is meant to ensure. Part of the operations of Mr. Dayaram's organisation is to raise awareness about the government schemes available in the area. In this respect the NGO workers conduct 'interviews' with the clients, and as Mr. Dayaram walked me through some

⁷¹ In this respect the opportunity cost is addressed in terms of lost income.

⁷² Throughout this thesis I have chosen to nickname this person Mr. Dayaram. We met in Uttarakhand on September 26th 2009, and I am very grateful for the contributions from this passionate and straightforward person, but I do believe that his openness and almost disrespectful (in the intriguing and well meant sense) way of formulating resulted in statements and arguments that I prefer not to ascribe his real name for the sake of the well running of the associated NGO.

⁷³ NREGA is short for the (Mahatma Gandhi) National Rural Employment Guarantee Act, which aims at enhancing the livelihood security of people in rural areas by guaranteeing hundred days of wage-employment (100 Rupees per day) in a financial year to a rural household whose adult members volunteer to do unskilled manual work. Panchayats at districts, intermediate and village levels is the principal authorities for planning and implementation of the scheme ("The Mahatma Gandhi National Rural Employment Guarantee Act", (2005), [online]).

of the questionnaires they used with answers from local women, it became quite clear to me that people's right to employment under NREGA was not common knowledge in the area.

Next, who gives you this work? They say; "Gram Pardan gave this work." But not Pardan, not the BDO, not the CDO and not anybody person, this is his right, his right to get this work, to get this job. But they say, Gram Pardan. (Monica: And what is Gram Pardan?) Gram Pardan is a village Panchayat. Head of the Panchayat, this is Gram Panchayat, Gram Pardan. Every family has a right to work. Nobody mercy, no mercy, no mercy Gram Panchayat, Panchayat secretary, no mercy village Panchayat Gram Pardan, no block officer, district officer. No mercy! This is our right, it is included in our constitution that you should have. But they don't know, they say; "the mercy of Gram Pardan we will take this work."

... Without work order, if you do any work, you don't claim for payment. After work order, if I demand some work, within 14 days the block officer give me work order. Then I will do work. Without work order I do this work, no payments, no claims, no any claim. (Monica: You can't claim payment?) Payment, so many, accidental claim and so many, our rights are finished. I ask, you know work order, she says: "no." She doesn't get work order, never get work order, she says; "mercy of Gram Pardan" ... If Government decided not give to you work within 14 days, than you have right to unemployment money, but for unemployment money your rights start when you write him for work. If you don't demand work you never [get it]. (Monica: And this was the block level?) Yeah, also village level secretary, Panchayat secretary also. If you write to them, he receive you application [which he apparently seldom does], and receive your demand letter, within 14 days they don't give to you work order, you are unemployed, which is a right. She say; "No, I don't know, what is unemployment?" Get only ten days [work]. They don't know.

If people do not have wage employment on the days of group meetings, which is likely if the trend of employment should be as low as ten days like Mr. Dayaram showed me from some of the questionnaires, the opportunity cost of attendance would not be a problem. Although, if group meetings are held on the few days (regardless of whether it is 10 or 50) that people actually have work, the opportunity cost might be extremely high.

The second assumption, that opportunity cost must be seen in relation to people having to attend meetings, was something that Father Francis expressed frustration with reference to during our conversation:

Once you say SHG nowadays, what I see is that they see it as a small bank, mini type bank. Give the money, go back. That sort of thing, nothing else. So I convince the people it is not a small bank business here. Thing is that sometimes to children no, they give the money [clients to their children], they say: "just go on, give to that lady," and then they go to the village for grass cutting or-. They don't even come for the meeting! I say, if this is the case, we shall stop it here, we shall break it here. This is not the purpose.

On the one hand, when people fail to show up for meetings, they miss out on whatever teaching provided by the NGO, the group unity might be weak, and subsequently the expected empowerment and the possibility to fight pressing issues may pass the clients by. But on the other hand, if merely one or two persons send their children in cases when they are unable to attend, all will still deposit the correct amount, no default is occurring, and the group

members will continue to have access to a safe place to save and a formal source from which they can borrow. The persons attending the meetings can furthermore raise their worries and try to find effective solutions to their problems regardless of whether or not all are attending. The cause of concern lies in whether or not people not showing up for meetings will lower the attendance discipline of all. If people starts to absence for the sake of convenience, and everybody feel that they should not have to go as their neighbours do not have to go, the social collateral, saving discipline, group unity etc. might all be at risk.⁷⁴

5.8 Are poor persons the clients of choice?

In the introduction to this thesis we saw that the Report of the Committee on Financial Inclusion (2008) documented that: “The poorer the group, the greater is the exclusion” (C. Rangarajan, 2008, p. i, [online]). This does not cohere with NABARD’s vision in respect of rural finance, which is: “To facilitate sustained access to financial services for the unreached poor in rural areas through various microfinance innovations in a cost effective and sustainable manner” (NABARD: Vision and Mission, 2007, [online]). Hulme argues that the assumption of microfinance automatically being about working with the poor and poorest needs to be dropped unless the MFIs can provide clear evidence that it is the case (Hulme, 2007, p. 20). Srinivasan reports that except by the government-sponsored programmes that are mandated to focus on the poor, studies and anecdotal evidence points to that it is mainly upper strata poor and not so much the ultra poor that is being covered through this approach.

In terms of coverage, well-endowed and high-growth areas have been prioritized. The expansion within such areas has also not consciously targeted the poor. The most vulnerable are not clients of choice, for most organizations engaged in SHG promotion or MFI lending. In poorly endowed, backward and remote areas, even the better-off among the poor do not get covered as these areas are not yet the microfinance map [sic]. Hardcore poor remain excluded; so are remote areas.

The very poor with no resources may not be fitting clients of the financial system till the time their capacities are built. The others are potential clients of the system. But banks and MFIs tend to cherry-pick their clients. The products and processes by design or default exclude the more vulnerable of the poor. Expansion into remote areas is fraught with risks and additional costs and long breakeven periods; hence the lack of focus on such areas (Srinivasan, 2008, p. 3).

During the bus ride to visit Aapni Sahakari Sewa Samiti Ltd., I got the opportunity to talk to a man representing an NGO working in the north eastern region of India. He and the man sitting next to him on the bus shed some light on one of the reasons why MFIs and the SBLP have not been able to, or interested in, putting certain areas on the microfinance map. The north eastern NGO worker began by explaining how the presence of microfinance in the rest

⁷⁴ The consequences of poor cohesion in groups will be discussed in chapter seven; ‘The quality of groups’.

of the country had passed them by and that it was not until recently that a couple of NGOs had become aware of the phenomenon. According to him though, this was nothing new as most sanctions provided by the Government of India seldom reached the area, or at least not the common villagers. As he was attending the Forum to learn more about microfinance, we began to discuss which approach would be the best option, the MFIs or the bank-linkage? He was very clear in his case; microfinance had to be provided through an MFI.

Because going to the government, state government will be of no help. Not at all. (Monica: Why?) You see, Government of India is really doing good things for giving good sanctions to the people of Nagaland and the surrounding areas, but the politicians, or bureaucrats, and a little bit of underground people is there, terrorist like, so this gets it. It never reaches the common people, not to talk about this poor people! (Monica: But can't the underground people become a problem?) No, not at all because now the underground people problem in Nagaland is solved, we don't have it. In Assam we have, and Manipur, apart from that we don't have much problem. So setting up this microfinance will never be a problem.⁷⁵ [A fellow participant took the recorder to comment on this and argued:] But the political situation of each state is different, so, they miss utilise the funds for their party's purposes or they make corruption and get into the family only, not reaching the other people. That is what is happening, that is why he said that the state government cannot help. Because each state has different political party ruling the state and those parties still believe that it is their own state and they can do whatever they want. (Monica: So in such places MFIs are better options than the SBLP?) But MFIs will not go, because organisational activities will be very difficult for them to manage. That is why they are not going.

According to a note in the *State of the Sector Report 2009*, "... actual coverage of poor is neither guaranteed nor clearly evident from several studies. Those below poverty line form a significant part of banks' and MFIs' customer base, but microfinance caters to non-poor and transient poor in large numbers" (Srinivasan, 2009, p. 21). The group lending approach in itself might work discouraging on the poor who fear that they will not be able deposit the weekly/monthly requirements, who do not have the time nor can afford to prioritise group meetings, who fear that the responsibility of having to cover for other group members or who fear being vigorously monitored by them. Based on what Dr. Anand at the UNDP office and I discussed, I will furthermore suggest that there is a need for segmenting the group of people that we refer to as 'the poor'. Due to the popularity of providing microfinance through a group based lending approach, some poor becomes less reached than others. Dr. Anand pointed out that amongst the group that is being target as BPLs (persons Below the Poverty Line) and/or relatively poor persons, there is a whole range of vulnerable people being excluded. Despite the fact that lending through a group based approach is aiming at including

⁷⁵ Expressed during the bus ride to Phagi, Jaipur, 25.06.2010. I am under the impression that this informant altered his response with regards to the 'underground people' as he was under the impression that I held a position to help him out, or to actually realising moving funds to the area, during the Forum. This is discussed in the methodology chapter of this thesis. I have chosen to include his statement regardless because he raises an important point even if his altered description is not coherent with his initial claim.

the poor and empowering them through SHG participation, the group lending approach as it is today might exclude the people that for different reasons are not strong enough, or numerous enough to link with the mainstream.

Certainly there is a need for segmenting the poor. There is a variety. Some are vulnerable, some are disabled, challenged, means physically and visually challenged, and some are senior citizens and poor and not even in SHGs. Those are all excluded, so right now we talk about financial inclusion and social inclusion, but there is a need for a more proactive approach. This means holding hands of those who are not included, because if they had that power they could have included in the mainstream. But the problem is because they were not strong enough to link with the mainstream, that's why they are still excluded. ... So I think if we can segment, and then after segmentation try adopt various strategies for inclusion. To give an example, you will not find five physically or visually challenged people in a village,⁷⁶ so than you can't form a group. You need a mechanism of individual lending also.⁷⁷

5.9 Balancing regulations and implementation

Despite the fact that default of one member supposedly is equal to exclusion of the whole group under the microfinance approaches (as this is the main factor which tackles adverse selection and moral hazard), it might prove to increase efficiency in the sector as a whole if this rule is not complied in an absolute sense. It can be beneficial for the sector if the group members who have not defaulted, and cannot be held responsible in case of a default, were allowed to continue to borrow and save while the staff merely tries to collect as much of the problem loan as possible (for example by using the defaulter's savings to repay) and only cut the person who defaulted (*if* that is called for) and replace her with an alternative borrower (Armendáriz de Aghion and Morduch 2005, p. 113). "This is a natural route to improving efficiency (and equity), even as it undermines the strict reading of group-lending contracts" (Armendáriz de Aghion and Morduch 2005, p. 113). However, this is a fine line to balance. On the one hand joint liability loses its quality to tackle adverse selection and moral hazard if the lender is too yielding. On the other hand, if the lender is not yielding, the rest of the borrowers (with deserving and profitable projects) will go unfinanced just because the first member of the group to obtain a loan defaulted and the rest of the group was not yet in a financial state to cover for her.

5.10 Does the group lending correct for market failures in the formal economy?

We have seen how lending through a group based approach can contribute to mitigate the market failures in formal sector banking as social capital has proven to substitute physical

⁷⁶ Five is the smallest number of members that can make up a group following the directions of the government. The number was lowered to five in order to enable the adoption of the SBLP in challenging geographic areas.

⁷⁷ UNDP Office, New Delhi, 08.12.2009.

collateral, and joint responsibility is able to tackle the problems occurring from imperfect information. But as we have also noted, group lending has its downsides. It might have a discouraging/excluding effect on (truly) poor people, it might be both time consuming and costly, and inefficiencies occur when good projects go unfinanced due to the default of a single member. These inefficiencies should nevertheless be seen in comparison to the non-defaulting, but still formerly excluded, members' probability of accessing formal services if microfinance had not been an option in the area. All the (formerly unbanked) members now accessing services through the microfinance approaches outweigh the number of clients being excluded due to these new inefficiencies.

The size of microloans

This chapter aims to discuss the relation between the size of microloans and the impact a loan has on the lives of poor persons. My suggestion is that the amounts being distributed under these approaches, as they are today, might be too small to successfully make an impact, or a real dent, on poverty (in terms of raising all borrowers above the poverty line). However, I will argue that a microloan might still help counter some of the core components of poverty such as hunger, health related issues, humiliation, extortion, discrimination and so on. This chapter begins with a discussion on the connection between income and nutrition which will enable us to say something about the impact microfinance might have on components of poverty. Next we will turn to the cost of climbing above the poverty line, and it is in this section I will present the reasoning for why I propose that a microloan might be insufficient to raise the majority of microfinance clients out of poverty. This part also provides us with the logic behind why there is still such a large dependence on informal credit in India.

MFI and donor hype has created the impression that microfinance is a cure for poverty. This is encapsulated in the work of the Microcredit Summit and the thousands of well-intentioned but misguided supporters who believe that microcredit is the answer to the problems of poverty. This is a potentially dangerous line of argument as it distracts attention from the fact that poverty reduction requires action on many fronts: social safety nets for the poorest and most vulnerable, an effective education system, low-cost and reliable health services, governments that can provide social inclusion (and thus maintain law and order) and sound macroeconomic policies, and many other issues (Hulme, 2007, p. 21).

According to the Reserve Bank of India (RBI) guidelines microcredit is the provision of financial services and products of very small amounts, not exceeding 50 000 Rupees.⁷⁸ In the *State of the Sector Report 2008* (p. 3) N. Srinivasan reported that the average loan per client, both in the case of MFIs and in the SBLP, was between 3 500 and 5 000 Rupees. In the *State of the Sector Report* one year later, he welcomed the development that average loan size had increased significantly, although particularly in the case of MFIs. Average loan size provided through this approach increased from Rs. 4 200 to Rs. 5 200 (Srinivasan, 2009, p. 4, 50), and in the case of the SBLP the average loan size disbursed in 2008-2009 was Rs. 74 000, ranging from Rs. 37 300 in the case of cooperative banks to Rs. 86 000 delivered by Regional Rural Banks (Srinivasan, 2009, p. 30). If we rely on the average of 17 to 20 members in a SHG (as

⁷⁸ The whole section is quoted in the 'Introduction' of the thesis.

found in data provided by Basu and Srivastava, 2005, and Harper, 2002, respectively) we find that per capita loan is somewhere between 3 700 and 4 353 Rupees through this approach.⁷⁹

According to Allen, these amounts should be well above what the poor need:

... [I]t is also necessary to recognize that the scale of their [the poor's] needs (and the priority) may differ from those of the not-so-poor and the rich. While the principal aim of better-off may be to access large, credit-based lump sums to finance full-time growth-oriented enterprises, the poor are likely to need very small sums (less than US\$20 and as little as US\$1), derived from a mixture of savings, insurance and incremental amounts of credit to manage their combined business and household cash flow (Allen, 2007, p. 56).⁸⁰

Based on what was made known to me during the fieldworks, I will, as others have before me, nevertheless stress that the average microloan provided in India might be too small.⁸¹ Writing this makes me feel a bit uneasy as it somewhat implies that microfinance is not a fitting tool for lessening the financial burden of the poorest among the poor,⁸² that easing liquidity problems is not important, or that a microloan should always be invested in a microenterprise. This is not what I wish to argue. For some an initial loan to purchase a sewing machine might enable them to work their way out of poverty, or be adequate enough for them to avoid having to borrow from, and promise loyalty to, a local lender. Some might merely need to borrow in order to cope with an unexpected medical bill or to attend a wedding in the village. In other cases though, and more often, truly poor persons have already accumulated a relatively large debt to an informal source and will not be able to pay off what they owe, while putting the rest towards an income generating activity and thereby come clear of their financial difficulties with a microloan of 4 000 Rupees. However, microfinance has the property to directly affect everyday concerns of the poor. To see this, we will turn to the relationship between nutrition and work capacity.⁸³

⁷⁹ A 74 000 Rupee group loan divided by 17 or 20 group members gives individual loans of Rupees 4 352,9 and 3 700 correspondingly.

⁸⁰ As per 04.10.2010, one US\$ equals to about 45 Indian Rupees and US\$20 is about Rs. 890.

⁸¹ This has been argued for example by N. Srinivasan in the *State of the Sector Report 2008*. Many of the participants at the Annual Forum also argued this.

⁸² Implying that the underlying idea of microfinance is wrong; that poor persons cannot be helped by an initial, relatively small, inexpensive and unattached loan. That such loans will not enable them to buy what they need for production purposes, produce something they can sell to whomever they chooses and earn enough money to pay back the loan with interests, still having enough left over to buy new inputs the next morning without having to reborrow.

⁸³ We are now only concerned with microloans. Microfinance is a much broader basket of services, which often complements the microloan. Many of these services (for example savings, a credit card or insurance) might contribute to ensure against households having to prioritise in the ways we will discuss below.

6.1 Income and nutrition

Let us now draw the concept of microloans down to regard the poorest of the poor. This is people that seldom invest their loans in risky projects or use them to start new micro enterprises, rather they borrow in order to smooth consumption and to cover external shocks (medical bills) or compulsory expenditures (participating and contributing in festivals).

According to Robinson, the first thing many poor families do when they experience a rise in income is to improve their nutrition and send their children to school (Robinson, 2001, p. 38). The benefits from improved nutrition, except the obvious avoiding death by starvation, is that there is a clear link between good nutrition and the body's capacity to perform income generating tasks.

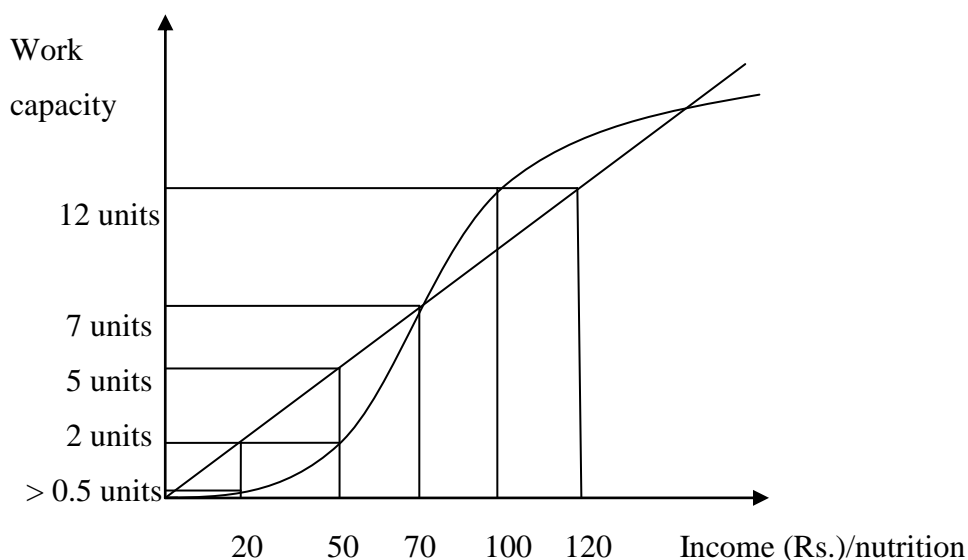


Figure 6.1.1, the Capacity Curve⁸⁴

The idea behind the capacity curve is that one can think of work capacity as a measure of nutrition in terms of total tasks an individual can perform during the period under review.⁸⁵

As we can see from the figure (by following the curved line from left to right and reading on the vertical axis how 'hard' a person can work relative to the nutrition he consumes on the

⁸⁴ The general data on the capacity curve draws on Ray's *Development Economics* (1998, p. 272-289).

⁸⁵ For the sake of simplicity I have made the assumption that all the income the person earns is spent on nutrition even though a more realistic assumption might be that only about 70 per cent actually is eaten.

horizontal axis), most of the initial nutrition goes into maintaining ‘resting metabolism’.⁸⁶ This translates into that a person’s work capacity does not increase proportionally with the amount of money he spends on nutrition. Once resting metabolism is taken care of we can see how the curved line raises steeply; this means that the person will be able to work much more efficiently with just a little more food in his belly. All the way to the top right the curve is flattening out, this reflects that there is only so much a person can eat and still be able to work more efficiently than what he did before (diminishing returns as the conversion of increasing nutrition into work capacity has natural limits). Now, not only is there a connection between how much/good a person eats and the effort he is able to put into his work, but there is also a connection between how much work he does and what he earns.

Imagine that the straight upward pointing line is the expression for what an Indian villager earns per unit of firewood he cuts down and brings to his employer. In this example we find that he earns ten Rupees per unit. What is important to remember at this point, is that the effort the man is able to put into his work is constrained by the capacity curve. From the figure we thereby can read that if the employee gathers five units of firewood; he earns 50 Rupees that day. The problem arises when the employee only have these 50 Rupees to spend on nutrition because the capacity curve reveals that he is only be able to gather two units of firewood the following day when he has eaten for Rs. 50. Two units of firewood result in a salary of 20 Rupees to invest in nutrition, but the constrain curve then reveals that the man will only be able to provide less than half a unit to his employer after having eaten for as little as Rs. 20. The man will not be able to work his way out of this situation until he by some means is able to buy food for at least 70 Rupees (which implies, as can be read in the figure, that he can provide seven units of firewood and earn a new 70 Rupees to spend on food). The capacity curve is naturally more suggestive than what it reflects an unconditional correlation. However, it enables us to see the benefits from a small microloan in the fight against poverty, or at least in the battle against one of the core components of poverty, that is, under nutrition. By taking a microloan of 100 Rupees the man is able to work more efficiently (provide more units relative to the amount he has to spend on food not to fall back down the constraint line), and thereby create a surplus of cash or time given that the repayment schedule and interest rates concur with his income flow. When the worker is able to eat for 100 Rupees he can work hard enough to produce twelve units of firewood. This effort will earn the man 120

⁸⁶ Resting metabolism refers, according to Ray, to the energy required to maintain body temperature, sustain heart and respiratory action, supply the minimum energy requirements of resting tissues and support ionic gradients across cell membranes (Ray, 1998, p. 273).

Rupees, and as he only needs to eat for 100 Rupees to keep up the intensity at work, he can save the 20 Rupees surplus and still make 120 Rupees the following day.

In this example we have held aside some very relevant points that will affect the data implied by the capacity curve. We have assumed that the employee is single (with no financial obligations), and does not have to spend money on anything but food. If we assume that he is the sole provider for a family of four, the income/nutrition have to be divided on four people instead of one. This entails that even if the man provides seven units of firewood, and earns Rs. 70, he is not in a position to eat for 70 Rupees. As we have established, 70 Rupees is the key number in this example. If the man gets less nutrition than this, he will slide back down the capacity curve.

Based on the workings of the capacity curve one can argue that there is a link between who makes more money in a low-income household and the division of nutrition in it. The well documented assumption that women in low-income families tend to be poorer than the men living in the same household directly relates to what we have discussed above (though other factors are of course also contributing to determine intra household discrimination).⁸⁷ One might not like it, but it is hard to reason against that the people expected to bring home the highest salaries should be given more of the household's resources (if the resources are scarce) as that in turn will feed more of the household's members. When such prioritising has to be made, this naturally contributes to discrimination within the household in terms of denial of nourishment, medical care and for example education. It is typically female household members and elderly persons that become discriminated against. This is because women tend to earn less than men, that is, if they perform wage labour at all seeing that women often have greater responsibility within the household (taking care of children, prepare meals, fetching water, clean the house, tend to the sick and so on), and because the old might, for natural reasons, be unable to go off and perform manual labour, and they are often less attractive on the job market as younger people typically are able to work more efficiently. I know I am crossing a line and am about to enter an ethical debate, but I cannot go there as it is not relevant for this thesis and I do not have the space to elaborate on it. My aim was merely to account for the economics that often work behind why many people prioritise as they do (the rational for why discrimination of some might be for the greater

⁸⁷ For example the article *Poverty: Background & Perspective* written by Mari Marcel Thekaekara address how women tend to be poorer than men living in the same household (2008, [online]).

good) and the effects of such prioritising. We will now turn to the impact a microloan might have on households with scarce recourses.

In respect of food deficient households a small microloan can do a lot of good. If we consider the example above, providing a onetime loan of Rs. 100 might be enough to enable the worker to create a surplus of Rs. 20 from that day onwards. This is only in theory of course,⁸⁸ but the theory allows us to see a tendency; a well nourished person is likely to work more effectively than a person starving. By focusing on the tendency, we will find that at, say, 15 per cent interest per month, a 100 Rupee loan can easily be repaid within a month. If the worker works six days a week, spends 100 Rupees on nutrition, and earns 120 Rupees each day of work, he is left with a surplus of 480 Rupees at the end of the month. The four Sundays he does not work he does not need as much nutrition and therefore eat less, say for 70 Rupees, resulting in a total of 280 Rupees. At the end of the month he is thereby left with 200 Rupees to repay his debt of 115 Rupees (the initial loan plus 15 per cent). The next month he begins by eating the rest of the surplus from the past month, 85 Rupees, not as much as Rs. 100, but still above the key number of Rs. 70 resulting in him being able to create further surplus. The rest of the family will also need food during the first month so naturally the man will have to take a larger loan in order to feed the other household members, and he is likely to have expenditures other than on nutrition, but this is not relevant for the point I am trying to make. Except for the period of repayment and the total sum of the interest charge, the mechanism is the same whether he takes a 100 Rupee loan or he borrows 1 000 Rupees.

A microloan, implying that there are no strings such as bonded labour attached to it, might enable a family to create a surplus that in time can contribute to create equality within the household (if we assume that for example alcoholism or the like does not drain the household's cash flow, and that the family is committed to prioritise necessities instead of luxury goods⁸⁹). A surplus might for example serve as insurance in case of an income earning family member falling sick, or cover medical bills of all the household members as there is no longer a need to prioritise nutrition for some over the health of all.⁹⁰ Nor would there be any

⁸⁸ People tend to spend money on other things than food, the worker might not meet employment everyday and he might probably not be able to convert nutrition into working capacity and further into cash as convenient as I did above.

⁸⁹ Alcoholism among men was one of the top reasons the NGOs I visited with in Uttarakhand gave when I asked them why they had chosen to direct their services mostly to women.

⁹⁰ In respect of covering medical bills I wish to include a statement made by Mr. Harish Chotani during his briefing of the theme based workshops at the Annual Forum, Jaipur, 23.06.2010. "If you go to the villages and you talk to people, not so much in the urban areas, you ask them how much they spend on own health you know, they will give you a range of something like 5 000- 10 000 Rupees in a year. That much of the money is equivalent to NREGA's 100 days of employment, if they get that." This implies that the surplus might need to be

immediate need to discriminate in terms of nutrition in the household, which in turn might contribute to more family members having additional income earning days each year seeing that a healthy body is more resistant to diseases and that better nutrition is likely to increase productivity. Children might be allowed to attend school longer as the family becomes less depended on them to bring in extra cash, or the family might be able to put aside cash to secure a daughters marriage with a good man. If a surplus covers the domestic needs, people furthermore avoid having to borrow in the informal sector out of necessity if this is something that they wish to steer clear of.

6.2 The cost of climbing above the poverty line

Christina Barrineau, the senior technical advisor to the Year of Microcredit, was asked in an interview what she thought the results of the UN's Year of Microcredit were, and according to Thomas Dichter this is what she replied:

People stopped seeing microcredit only as a ten-dollar loan to a woman buying a goat, and started seeing the poor as masterful business people, tremendously entrepreneurial – people who have fundamental business skills and really warrant access to financial services that will help them grow their wealth (Dichter, 2007, p. 1).

Dichter continuous to argue that the “view that the poor as budding entrepreneurs, who, with access to formal financial services, would pull themselves out of poverty, through business development, asset accumulation and wealth creation lies at the core of the new high profile of microfinance” (Dichter, 2007, p. 1). In the following parts of this chapter I will contest this view mainly for two reasons. First of all, not all poor wish to, have the investment opportunities to, or the business savvy to become self-employed entrepreneurs. Second of all, the size of the loans that people receive as microfinance clients might restrict the possibilities that they have to “unleash their entrepreneurial instincts” (Dichter, 2007, p. 1).

According to Kamakar, several cycles of lending in SHGs may result in reversing the conditions of abject poverty and ensure that production/investment credit is met eventually. “In other words,” he writes, “the SHG members are developed into microentrepreneurs. This process is necessarily long and takes time” (Karmakar, 2008, p. 15). But not all poor wish to become, or have the opportunity to become, self-employed entrepreneurs. Hulme and Mosely advocate that opportunities for credit-financed self-employment are very limited for the

rather large for a family to cover health expenditures without falling into debt, and it post a strong need for health insurance among the rural poor.

poorest, and that the risk associated with self-employment is unreasonable high (Hulme and Mosely, 1997, p. 123). Food-deficit borrowers who are unable to utilise their credit, or to market their output, may end up having to eat their loan. In turn, such an event can “lead to humiliation and the diminishing of an already low level of self-confidence” (Robinson, 2001, p. 21). To minimise risk many poor therefore prefer to work as wage labours for others (Fisher and Sriram, 2002, p. 27, 77).⁹¹

The most common example people referred to when I asked the participants at the Annual Forum their opinion on the average size of microloans was that it costs (depending on who answered) between 30 000 and 50 000 Rupees to buy a buffalo. “And also you know, the whole microfinance limit of 50 000 needs a relook. To buy two buffaloes today, which is at minimum around 60 000 Rupees, definitely doesn’t fit into microfinance, and at least four animals are needed today for a household to come out of poverty.”⁹² Let us assume that a client has been in a group for several years and is in her third or fourth loan cycle allowing her to take larger loans. At most, as per the guidelines of the RBI, the woman can take a 50 000 Rupee loan. According to some of the participants at the Annual Forum, this will buy her one animal.⁹³ I am not trying to say that one animal is worse than having none, but if the revenue to be gained from just one animal does not cover the cost of acquiring it, the client is stuck with a large debt and a new animal to feed. If the client find herself bound to sell the animal, her bargaining power is likely to be low, and she might have to sell it for less than what she paid. Another concern refers to how borrowers that have been able to invest their initial loans in an income generating activity, for example by establishing a small shop, might experience trouble with staying above the poverty line as long as they only are allowed to borrow Rs. 50 000 at the time. Not only can they not borrow more than 50 000 Rupees, they also have to repay the whole amount before taking a second loan. The following quote summarise the point I am trying to make well. “Sir, my requirement is huge, because I need around one lakh [Rs. 100 000] working capital, but these people are giving only term loans which I need to repay immediately, then I cannot maintain my stock.”⁹⁴ A relevant question in

⁹¹ The already economically active poor often have more investment options. They know their business and understand their financial needs well, something that makes them better fit to expand their enterprise or to diversify their investments to avoid risk. Focusing on less poor might also result in more wage labour becoming available to the people who fear self-employment.

⁹² Ms. Chandra Singh representing the NGO MYRADA provided this statement during the round table of the *State of the Sector Report 2010* (Jaipur, 23.06.2010).

⁹³ Naturally the client can by hens instead of a buffalo, and she might sell the eggs to finance the hens, but for the validity of the discussion let us assume that it is buffalos she needs as that is what most of the participants referred to when we discussed the amount needed to climb above the poverty line.

⁹⁴ Stated during the roundtable on the *State of the Sector Report*, Jaipur, 23.06.2010.

this respect was raised by one of the other participants at the Forum during a bus ride we took to visit with Aapni Sahakari Sewa Samiti Ltd. in Phagi: “Even in India, in certain situations, a buffalo cost more than 50 000 Rupees, a good buffalo. If you give loan of only 20 000 Rupees, the 30 000 balance, where he or she will meet?” Given that the profit of having one animal outweighs the cost of acquiring it, a microloan might still be insufficient to purchase the animal, and the client must meet the balance elsewhere. The same goes for the person who cannot maintain her stock. If she chooses to complement her formal borrowing from a local lender, we once again face the scenarios we discussed in chapter four.

In the “Report of the Technical Group to Review Legislations on Money Lending” it is stated that: “Notwithstanding concerted and multi-pronged efforts to extend institutional credit to all sections of society as also other initiatives for increasing the outreach of banks by using SHGs and MFIs as intermediaries, the dependence on moneylenders has not decreased in rural areas and has, in fact, increased in several regions” (Gupta (Chairman), 2006, p. 11). The interlinked transactions and bonds of loyalty working in the informal sector affect the dependence on informal sources, but seen in light of the argued outreach of the microfinance sector, and the fact that microfinance in India indirectly set out to challenge these relationships (directly by providers who offer debt-swap schemes), there appears to be a fault in the mere practise of microfinance as the dependence on informal finance is still strong.⁹⁵ Based on the statements above I will suggest that this default might partly be explained by the size of the microloans.

6.3 Graduating into mainstream banking

Another point that relates to the size of microloans is the problem of graduation from a SHG membership to being able to take an individual loan. In theory this sounds quite straight forward; build an assets base during the group membership and when you are no longer

The quote is retold in full in chapter eight, and we will discuss the problem of staying above the poverty line (by maintaining the stock) shortly under ‘Graduating into mainstream banking’.

⁹⁵ However, clients might now be in a position to renegotiate better terms with their respective lender based on the possibility of obtaining formal credit. If we rely on the anecdotal data reported by N. Srinivasan presented in chapter four it should be just to argue that given that a local lender’s monopoly power is being challenged by providers of microfinance, the ‘something extra’ services that lenders provide in order to keep clients from shopping around for credit also is affected by the infused competition in the credit market. Viewed from a different angle though, if clients need to borrow from an informal lender in order to cover their outstanding formal debt, the moneylender has the upper hand and might raise his interest rate. If the client turns to the lender in desperation because a whole group of people, SHG members and staff from the respective institution or organization who rely on that the one person about to default repays, might impose extreme pressure on the borrower, the lender’s bargaining power becomes strengthened.

vulnerable or have enough savings or resources to post as collateral, you go to the bank and get an individual larger loan. In practise, I learned, it was not that easy.

Initially, what we have been thinking in SHG programme, once the members who exhibits some three or four loan cycles track records, than they will be graduated to the mainstream banking as individual clients. So when I was working in the retail banking, only some five per cent of such clients actually graduated to that level, but during that time also, when we interacted with such clients they felt unhappy with dealing with the bank because when they were in groups they got collateral free loan. When they mainstreamed into the mainstream banking they need to go through all the collateral steps and all which they were unable to fulfil. The group got five lakh [500 000 Rupees] loan immediately showing their track record, but as an individual for taking just one lakh or two lakh loan she found it very difficult. She could not establish contacts and convince the managers. They were all saying [the managers] there is rules only, saying there is no scheme like that only.⁹⁶

There is no doubt that some long established and well functioning groups can obtain sufficient credit for some of the group members to build an assets base that will be accepted as collateral in the formal banks. However, the 50 000 Rupees limit might restrict clients from reaching that state, as might the group lending approach. First of all, as we saw in the former part ‘The cost of climbing above the poverty line’, people sometimes need more than 50 000 Rupees just to maintain their stock and keep their investment profitable. If their small shop is not sufficient to post as collateral for amounts larger than Rs. 50 000, the borrower will possible have to sell everything that is in her shop each time before filling it up again in order to repay the initial 50 000 Rupee loan and being granted a second loan. That is if the borrower is not in a group in which sequential lending is a requirement, then she might not obtain a second loan until a number of other group members also have borrowed and repaid their loans. Odds are that a business with a very limited range of merchandises left (only the products that others have not found worthwhile to buy yet), will not be very attractive. When money stops coming in, or comes in at a very slow pace, making repayments becomes hard. Had the borrower half way into the repayment period of one loan been granted a second loan (or been granted a larger loan the first time around), she could have refilled the most popular goods while still providing the less attractive commodities for those who suddenly should need/want that particular unpopular colour on a fabric or a new radio.

Because of the 50 000 Rupee limit it is reasonable to argue that a person who wish to graduate from group lending wish to borrow even larger amounts.⁹⁷ As we saw in the former

⁹⁶ Roundtable on the *State of the Sector Report 2010*, Jaipur, 23.06.2010.

⁹⁷ The motivation from some to graduate into mainstream banking can also be that they are unhappy with the requirements that being in a group put on them, that they merely wish to have access to formal financial services on the same terms that the non-poor have. However, as we will discuss in the next chapter, and as we saw the

quote obtaining larger amounts for the borderline poor (or no longer poor per the definition in this thesis) can be problematic. Below we will see how this might also work inviting for the people who are not poor to engage in microfinance.

Mostly people [in the farming sector] take working capital as their loans. They require 5 000-6 000 Rupees per acre going by the theoretical assessment, which comes to about 50 000- 60 000 per annum if there is one cycle of crops. If there are two cycles of crop, definitely same money will be rolled out again. So there is working capital need of 50 000 say for five acres. The land costs, as it is of today, one lakh Rupees per acre. That comes to five lakh Rupees of security. For a 50 000 amount of loan, that whole land has to be mortgaged to the concerned bank or lending agency. So it is injustice on part of lending agencies. You see, if I extend loan to an industry, I am satisfied with 10 to 20 per cent of security, primary security and collateral security put together. But when it comes to extending loans to farm sectors, the poorer sectors, security is ten times what the loan is. If you take 50 000 loan, then your whole of land is mortgaged. Everywhere you go you have a stamp on that, that this land is mortgaged to such and such bank, so this is first of all an injustice to this sector.⁹⁸

A red thread in this thesis relates to why the number of microfinance accounts is larger than the number of poor households. There is one rather clear connection that can be read from the quote above; if a person participate in a SHG (say one made up by richer persons who can accumulate a rather large savings pot fairly quickly) she will be granted a microloan up to 50 000 Rupees without putting forward external collateral and with few questions asked by the banker. If she is not in a group, she might have to mortgage five acres of land to obtain the same amount. For this reason it can be suggested that the workings in formal banks, their procedures, regulations and sometimes even handling of clients that are not well-offs, might both discourage the relatively poor from graduating, as well as be too cumbersome for the middlemen (those richer than the poorest but still poorer than the well-offs) to obtain formal credit, and thereby invites the people (just) above the poverty line to take advantage of the financial services that were initially meant to be directed at the poor. If less-poor start, or engage in, SHGs in order to enjoy the comparatively hassle free services of microfinance, this affects the reported number of poor households that are actually being reached through the microfinance approaches.⁹⁹

There is one more issue that needs to be addressed when we discuss graduation from group lending; what happens to the members who are not ready to graduate when people

theory working behind in chapter three that is seldom an option before the poor can post acceptable collateral, i.e. is no longer poor per the definition in this thesis.

⁹⁸ Expressed on the bus ride to visit with Aapni Sahakari Sewa Samiti Ltd. in Phagi, Jaipur (25.06.2010).

⁹⁹ If we consider that poor people sometimes dislike, fear, or becomes powerless in terms of making decisions being in a group with richer clients (something which will be discussed in the next chapter), we might also view richer people entering SHGs with poorer clients as serving an excluding/disabling factor for the poor that initially was meant to benefit from microfinance, or as a factor that even makes poor clients retreat from group membership.

begin to leave the group? The ultimate scenario would be that all the group members were able to graduate at the same time. For this to work out, it is important that the group has received adequate training (financial literacy), established a good saving and repayment discipline, and that the clients follow each other in terms of loan size and savings during group membership. If one person has been a member of a group simply to access a safe place to save, she might still be in her first loan cycle when others are graduating, and if seven people graduate from a group of seventeen, the group's savings (material collateral) will be severely reduced, as will the social collateral the group constitutes as in the eyes of the provider. It might be hard for newcomers (substitutes) to enter the group as they will have to match the savings of the 'older' members, and it might not be desirable to invite richer persons (who will have less trouble raising the required amount) into the group because of local power dynamics that thereby can become transferred into the group democracy.¹⁰⁰

Microfinance is, as the name imply, an incremental approach. It should therefore not be expected to generate instant results, and graduation to mainstream banking will thereby also take time, but how long is too long? Are there flaws in the design through which microfinance is being provided that restrict poor, in the process of reaching a not-so-poor state, from becoming non-poor? Inspired by the discussion on graduating clients during the roundtable on the *State of the Sector Report 2010* at the Forum, I will suggest that there appears to be a need for making the transition from group lending to individual lending easier, and I am under the impression that the time aspect regarding clients not being able to borrow more than 50 000 Rupees at the time (after having proven capable of repaying large sums) might disable borderline people from climbing above the poverty line and staying there. I do not know how, and even if, a specific graduate product will be realised, but I do recommend that it should be looked into as there in my view appears to be a need for it.

¹⁰⁰ This will be discussed in the next chapter; 'The quality of groups'.

The quality of groups

This chapter aims to examine the quality of groups. With the word ‘quality’ in reference to self help groups I mean that a good group should possess, or be characterised by, certain qualities in order to function well both in the eyes of the provider and in terms that benefit the members. A good quality group is characterised by a strong saving and repayment discipline, by cohesion, enthusiasm and goal-oriented action. In such groups all the members actively participates in the meetings, and they discuss, seek solutions to, and if possible address concerns such as alcoholism (with its accompanying problems), child marriages or for example a violent husband. Financial literacy among the members needs to be adequate, the collective wisdom of the group should colour the credit decisions being made by individuals, and all the decisions the group as a unit makes should derive from collective leadership. The quality of a group is important as all of the attributes listed above contributes to determine the sustainability of the group, the potential empowerment of the members, and to reveal how well its members will function as social collateral / social capital in securing loan repayments, both in terms of peer pressure, assisting troubled members and covering for members bound to default (as members of a quality group can be expected not to default strategically).

The first issue we are to address in this chapter relates to the mix of people that makes up the best groups. After a discussion on homogeneity, we will move on to see how the processes through which groups are formed affect the quality of the groups. This will lead us to addressing how the requirements for forming a group (the processes) have begun to affect the way clients perceive self help membership. The last part of this chapter will tie together the issues we have addressed by discussing the risks associated with low quality groups.

7.1 Homogeneity in self help groups

What form of social ties that makes up the most reliable groups in terms of repayment and empowerment has been tried answered by many a scholar and practitioner of microfinance. As can be seen in the empirical evidences presented by Armendáriz de Aghion and Morduch (2005, p. 99-108), there is no simple answer to this question as different factors play different roles when it comes to securing loan repayment. They report, for example, that borrowers living in close proximity are better able to monitor each other and in that way increase the

likelihood for repayment, while in other cases, groups made up by friends, neighbours and maybe even family (people living in close proximity) is reportedly softer on each other which reduces average repayment rates (Armendáriz de Aghion and Morduch, 2005, p. 99-108). Rankin's study in Nepal shows that women tend to self-select group members that possess significant assets, or who is from an identical caste or have the same ethnicity (Rankin, 2006, p. 102). Based on that people are expected to be risk averse, it is not unlikely that this phenomenon is relevant in the Indian context as well. Gunasekaran argues that group members "are expected to have similar social identity, heritage or similar occupations in order to maintain its coherence and smooth functioning without much conflict" (Gunasekaran, 2010, p. 114). And according to Dr. Anand at the UNDP office, the characteristics of homogeneity are changing:

Earlier there were religious groups, there were caste-based groups, but now through SHGs these social networks, the point of affinity for the social networks, is economics and livelihood. Not caste and religion. The fabric is different, like Hindus, Muslims; all are joining together for their social and economic benefits.¹⁰¹

In my view the best requirement for forming a group might be economic equality as people with equal economic background probably face a lot of the same pressing issues. A woman can find comfort in not being 'the only one' who struggles to feed her children, who is in bonded labour to a patron that takes advantage of her, or who goes home to an abusive husband who has spent the family's income on alcohol. Moreover it is more likely that such problems will be addressed in group meetings if no superior member possesses the power to undermine the importance of the poorer members' realities, and if people feel less shame discussing them because the rest of the members also face similar problems. In chapter four we found that an economically superior villager was likely to be superior in terms of social status and perhaps political importance as well, so if we mix richer persons and poorer persons in the same group, it is possible that the richer client will be in a position overrule decisions suggested by the poorer (financial as well as non-financial). She might be more educated and thereby possibly more literate and have better communicative skills vis-à-vis the poorer members and she is therefore likely to take, or be delegated, a position as the leader or spokesperson for the group. Furthermore, the inferior members might find it problematic to criticise, or denounce, a richer member if she does not take actions that benefit the group as a

¹⁰¹ New Delhi, 08.12.2009.

whole (for example ‘rules’ over the groups credit and distribute it as she pleases) due to her superior status and probably also influence in the community.

Viewed from a different angle, one can speculate that the benefits from having a richer person in the group is that this person might have less respect (in a good way) for authority persons, and thereby pressure the other members to raise their voices against injustice, or be able to take up, and present well, the group’s concerns or requests directly with relevant government official, banker, Panchayat or the like. Furthermore she is in a stronger financial position to cover for members defaulting and thereby ensure that the group continues to have access to formal financial services. But is power imbalance within a group a larger problem than it is a good? Seeing that the whole concept of SHGs is to enable the poor to act and speak as a group, and to stand together against injustice, that the meetings are meant to be a platform for raising issues that the group members struggle with, and that the staff attending these meetings are expected to assist the group in order to find the best possible solution to any problem, to educate them, and to help them realise their goals, I believe that it might at least be an unnecessary risk to take.

7.2 The processes through which groups are formed

The process through which groups are formed is likely to affect the quality of the groups. The reason why the SBLP require a six month training period before a group is linked with a bank (in theory), is to ensure that the group is capable of, and willing to, take on the responsibility of having relatively easy access to financial services, and it is to ensure that the group members have all the necessary prerequisites for experiencing empowerment in financial as well as non-financial terms. Several of the people I talked with during the fieldworks therefore expressed to feel a bit alarmed when they discussed group formation as many of them were under the impression that the processes now are being cut back on in the name of personal winning, reaching targets and becoming significant players in the eyes of donors.

The following first three statements were uttered during the Annual Forum and show how some of the participants feared that providers of microfinance have begun to focus less and less on the quality of groups by taking shortcuts in the initial group formation process in order to make more groups faster to earn more incentives.¹⁰² The fourth statement is included to provide an alternative perspective which also might contribute to explain the rush of getting

¹⁰² This will also be addressed in the next chapter concerned with excessive competition, though there the focus will be on the processes rather than on the outcome.

through the initial months of forming quality groups. During the roundtable on the *State of the Sector Report 2010* Mr. Harish Chotani was the first to raise his concerns in this regard:

But my personal feeling is that in the last two years in the SGH system ... I don't see at the grass root level any worker who is asking somebody to form a group for the group sake. They simply say: "Didi, sister, you want money? Form a self help group I will see to it that you can have money." This has become the situation now, which very clearly says that there is greed pollution.¹⁰³

A fellow participant acknowledged Mr Chotani's arguing and said:

Here in north I have seen that the people do want to take the shortcuts, whether he was mentioning the SHG vs. the JLG [joint liability groups]. We used to prescribe seven days training for the JLGs, probably now JLGs training would be happening in one hour. One hour, one hour before the group's recognition test and what they have to know that is what amount of loan they are going to take, what is their starting amount and how long they have to pay. ... Before the people were seriously doing those processes, now the processes have been shortening in the name of innovations, because people are hurrying to deliver the money.

A third person at the roundtable raised his arm to comment on this and offered the following experience with the phenomenon:

In fact, I was overhearing the conversation between my wife and our servant maid. She said [his wife] servant maid wondered quickly to go away, she said [the maid] I have to go to this organisation to get a loan, she said [his wife] last time you said you were with some other MFI, she said [the maid] I'm still there madam, this is a new company saying they are willing to give me so if I don't go in time I lose this. Please let me go.

The whole problem is staring with implementing of innovation is changing the SHG methodology. Earlier we waited for six months to give them the loan. We assured they were all properly trained and that they were really empowered with information and capabilities and all that. Nowadays what is happening is morning just form somebody as a group, and in the evening start lending.

During my first fieldwork, Mr. Kunwar at HARC also addressed this problem, but he approached it from a different angle. Rather than to put all the blame on the carelessness of banks, NGOs and MFIs, he pointed his finger in the direction of the government's targeting of self help groups.¹⁰⁴

Mr. Kunwar:	What's happening is that, see, I'm a Government servant, given a target that within two months I have to make ten SHGs or else I'm fired. So than what will I do? (Monica: You will make ten SHGs!) And that is the only way I can make ten SHGs.
Monica:	Will the government tell him to make ten SHGs or else be fired?
Mr. Kunwar:	Yes. But you see, it's not the, it is target oriented. We have to achieve the target that this year we will have to make X groups. So there are certain SHGs that have never been made through a process. When they are through certain processes they are good SHG, and those are mostly formed through NGOs as they have taken the time to

¹⁰³ Jaipur, 23.10.2010.

¹⁰⁴ Kaleshwar, 26.09.2009.

develop them. The Government has not the time to spend so much time for a particular SHG, they cannot.

Monica: Will he be fired him if he can't ensure a 100 per cent repayment from the groups also?

Mr. Kunwar: It is like, automatically he'll be fired.

Monica: So he'll put a lot of pressure on the women?

Mr. Kunwar: He will not even put the pressure on the women, he will simply go to a powerful person in the village and say; "please, this is my problem," then the powerful villager will help him.

Monica: That can't be good. I can see why it is effective, but—

That the processes through which groups are formed have been cut back on became quite clear to me during the fieldworks. This does of course not apply for all NGOs, MFIs and banks engaged in group formation, but according to the people I talked with it was not a phenomenon restricted to only a few areas either. This tendency possibly results from, and should therefore be seen in connection with, the increased competition in the sector of microfinance. We will discuss the scale of this amplified competition the following chapter.¹⁰⁵

7.3 Forming a group for the wrong reasons

The other side to this coin relates to the people taking a loan. As in the situations describe above, the motivation that encourage people to form a group will also affect the quality of the group. The main reason why most clients of microfinance choose to come together in an SHG is to access a safe place to save and to obtain (relatively inexpensive) formal finance. Other benefits such as access to insurance, money transfer, leasing services and pension schemes are now gaining importance, but the supply of financial services like these is still lagging behind in terms of accessibility. If people have to invest a lot of time and money in order to obtain a formal loan, this is likely to affect the quality of the group positively, and given proper training and encouragement, the group members is hoped to come together and assist each other in non-financial areas of life as well.¹⁰⁶

Several of the people I talked with during the fieldworks reported an increasing trend of clients, and possible clients, showing little interest in building quality groups. I will suggest

¹⁰⁵ In this respect I am of course only talking about genuine providers of microfinance. False companies pretending to be MFIs just to gather people's savings and then run off with it in the middle of the night does naturally not bother to spend as much time forming and grooming SHGs, but their agenda is also not to create strong, viable and sustainable 'micro banks,' if one can call an SHG that.

¹⁰⁶ As we saw in chapter five, the adverse impact of time spent together can be that members who know each other better become more reluctant to inflict penalties on those who default for reasons which the rest of the group sympathise with. The way in which the microfinance approaches hope that such a scenario will play out, is that the other group members will cover for the defaulter, their friend, until she is back on her feet. The possibility for such an outcome will of course vary with the other members' resources, the size of the amount involved in default, the others sense of responsibility for the welfare of the defaulter, reason for defaulting and implemented consequences on the rest of the group if one member cannot repay.

that this is connected with what we documented above; that it is no longer a strict requirement in all microfinance promoting and providing institutions that groups go through extensive training and creates an assets base by saving and interloaning before they obtain credit.

There is actually no big secret to this trend. Imagine that you, the reader, wanted to apply for a loan, but when you got to the bank, the branch manager told you that you first needed to find 10-20 other people that were willing to co-guarantee for your loan. Not only that, you would also have to pay if one of the other members in the group you joined defaulted, and you would have to attend weekly, bi-weekly or monthly meetings where you would have to deposit a (fixed) amount of savings every time. If you fail to show up for a meeting you will be fined. If you suddenly find yourself short of cash for a meeting being held on Friday, as you do not get paid until Monday, a large group of people might come and sit outside your house (or worse) until you are able to get a hold of the money you are expected to deposit. On top of this, the group decides on an extra interest charge that will be put on your loan additional to the rate of interest being charged by the bank.

Viewed from this angle, it should not come as a surprise that the poor also wish access to the same financial services that you and I have. Microfinance through group lending can in this respect be seen as a ‘second-rate service’, as Harper calls it. He draws the parallel between group-based microfinance delivery systems (as temporary low-quality expedients) and shared toilets, primary schools of 60 children and clinics without doctors. “These are the best that can be provided at the present time for some people in some places, but they are recognized as fundamentally unsatisfactory. Microfinance groups are the same” (Harper, 2007, p. 36). What still encourage the use of a group lending approach is that the disadvantages of this form for financial inclusion might be outweighed by the advantages of having access to formal finance. I agree with Harper that group lending should be a temporary stop on the path to individual borrowing, but for many this is, as of yet, the best available option. Exclusion from the formal economy is in most cases due to deep rooted market imperfections in the sector, and the practice of group lending has proven to tackle many of these flaws. This is also the reason why many of my informants expressed a deep concern with people taking advantage of micro financial services without respecting the group lending methodology.

Only a couple of minutes into the conversation I had with Father Francis, the Father expressed a concern with what Mr. Dayaram called the ‘subsidy culture’ of people:¹⁰⁷

¹⁰⁷ Quoted in chapter eight.

So as I said; the moment you enter the village, what they say is: “Sir, what are you going to give us?” They know we are coming from an institution, and that the institution has a project, and that they have something to give us. So what are you going to give us, that is the first question. Therefore, to form SHGs is very difficult.¹⁰⁸

During the roundtable on the *State of the Sector Report 2010*, Mr Dubey and Ms. Singh put it this way:

They have the back to back centre meetings. Ten o'clock this meeting is happening, eleven o'clock that is happening. On Wednesday two centre meetings, Thursday two centre meetings, one centre meeting is happening on Friday. They know, or they don't know, [even] the names they don't know. This one gave 250 [Rupees], that gave 300, another gave 230. They know- ... that's it.

“They associate with the leader you know,” Ms. Chandra Singh replied.

7.4 The risk associated with low quality groups

If people agree to form SHGs just because they want a loan (and I do understand this wish), the potential non-financial gains from being in a group is likely to go by unrealised. Forming groups without being interested in, or having to go through, the training and grooming period might nevertheless have negative effects both for clients and for the providers. Some groups might be made up by quite a few persons that have no interest in actually borrowing, but that have been told to join by other villagers who plan to get into debt. Based on data gathered in Peru, Wright argues that a highly personalised nature within groups makes it hard for group members to denounce a corrupt leader. According to her, the outcome of microfinance is directly affected by the wider power dynamics which shape social interaction (Wright, 2006, p. 159). If we accept this statement, one can suspect that similar problems exist in the Indian SHGs also as we here too find a high reliance on personal bonds seeing that it might be essential for a household's survival to foster and maintain good relationships with kin and/or patron. This argument implies that some villagers have the power to request that others should agree to form a group with them just because they say so. From what Mr. Kunwar expressed, the person requesting that other villagers should join/make SHGs does not even have to be a member of a group themselves. “He will simply go to a powerful person in the village and say: ‘please, this is my problem,’ then the powerful villager will help him.” If the ‘collateral’ members do not fully understand what obligations agreeing to co-guarantee for a loan taken by another person entail, they may involuntarily be dragged into debt. Some are not forced

¹⁰⁸ Uttarakand, 26.09.2009.

into becoming members; they simply choose to lend their names out as proxy borrowers against a fee. N. Srinivasan reported a case in which a woman had borrowed “Rs 4 million from different MFIs using several individual women as members of group [sic]. These members had contributed to a chit fund run by woman entrepreneurs with the help of the money they borrowed from the MFIs” (Srinivasan, 2009, p. 73-74). When some of the members failed to repay the chit fund, the lady who ran it fled which resulted in widespread default by many members to the tune of 4 million Rupees (Srinivasan, 2009, p. 74).

The initial processes of group formation are also meant to enhance financial literacy. There is little doubt that the poor understand their needs, and that the poor are capable of utilising a loan in the most beneficial way for the family, that they understand interest charges, and that they are capable of paying back money borrowed (at fair terms). But one of the participants at the Annual Forum raised the following point: “Literacy is in terms of understanding the advantage of insurance, the advantages of savings, and so on. If somebody decides to cut back on expenditures, for example say let’s have a low cost marriage, than it is financial literacy.”¹⁰⁹ For financial literacy to be exhibited in this term, the support of being part of a group might prove beneficial. If a marriage reflects the status of the client, the client might be tempted, or expected, to spend more money on the wedding celebrations than what he or she (or their families) can afford. Having to borrow money in order to arrange a wedding is not a new phenomenon, but when it happens it does witness about that social status trumps the financial literacy people are expected to exhibit. During the Annual Forum one example was given though which shows how social status in fact took the backseat during a number of weddings: “In Rajasthan we can see an example of this. In a small district 25 000 marriages happened in one day, in a single function! That is financial literacy.”

The fear among my informants for low quality groups can be summarised as follows; if groups begin to lose their reputation as a substitutes for physical collateral, providers of microfinance might begin to rethink their involvement with poor clients and one might expect to find even greater reluctant to serve the formerly unreached segments of the population. Engaging in microfinance might furthermore contribute to make the lives of poor borrowers even more rigid (involuntarily) if they do not fully understand the responsibility a group membership entails, and the process of empowerment have little chance of being realised if the quality of the group is low.

¹⁰⁹ Expressed during a thematic workshop on Policy initiatives, programmes and projects for financial inclusion, Jaipur, 23.06.2010.

Competition leading to an overestimated outreach

If we recall the discussion about competition in chapter four, we know that healthy/perfect competition should lead to a scenario in which clients (the demanders) are at the centre of attention. Providers of microfinance (the suppliers) will force each other to improve the services they supply (or not yet supply, for example insurance, credit cards, mobile cellular banking, or training of some sort) and make it available on better terms (such as larger amounts, longer repayment periods or shorter time to process loan applications) at lower costs (at the interest rate reflecting the cost of providing the product). The down side to competition is that pressure on institutions and organisations to reach clients might result in lower quality services, an increased pressure on clients to obtain formal debt and harsher practices in redeeming money. In India the excessive competition in the sector has to a certain extent manifested in the form of multiple lending/borrowing. Multiple lending has in many cases led clients to accumulate more debt than what they are capable of handling which have resulted in poorer loan recoveries and allegedly even poor farmers taking their own lives. This is a worrying development which needs to be addressed. The aim of this chapter will be to examine in what ways the sector and policy makers creates, as well as cope with, the problem of multiple lending. The chapter begins by discussing the processes leading up to this development by taking a closer look at the competition that is going on between providers of microfinance. As we address the competition amongst bankers, organisations and MFIs in the Indian sector of microfinance, we will also touch upon how this competition might have lead to lower quality services being delivered by providers of microfinance, and we will explore the quality on the argued financial inclusion of banks. In the latter part of this chapter we will discuss multiple lending/borrowing, how it results in an overestimated outreach of the sector, and the gap between regulations and implementation which has been argued to allow multiple lending to take place.

8.1 Competition in the sector of microfinance

Competition between the providers of microfinance is mainly in respect of market share, clients, funding and staff. “NGOs compete within the same area to mobilise people in the groups and to have a larger number of groups mobilised so that they become significant

players in the eyes of donors, funders and lending banks” (Srinivasan, 2008, p. 85).

Srinivasan reports that some banks compete with each other in terms of providing NGOs with cash incentives to link groups to their branch (Srinivasan, 2008, p. 85), and the banker I talked with in Uttarakhand expressed how they attracted clients by offering a revolving fund from the government for 10 000 Rupees to boost group activity as soon as a group chose to, and qualified for, linking with the branch. “Everybody in the area gets it!”

Although the banker was excited by this offer, a rural NGO worker also operating in Uttarakhand expressed a concern with regards to the incentive and the effect it could have / have had on the quality of the groups in the area. The following section is a part of the conversation between NGO manager Mr. Dayaram and me.

- Mr. Dayaram: The reason for the first grading is failure of Government side. After first grading government will provide 10 000 Rupees for, just like rewarding fund, but government have not money, so they are sliding to sliding this programme.¹¹⁰ One, just like our group’s grading is date in August, but government haven’t money, so they are not creating proper time, they are slipped on. They will be in September, October. Government have not money, so government not provide the subsidy for banks, than banks not provide loan for SHG.
- Monica: So government does not provide subsidy to bank, and then the bank not provide the loan?
- Mr. Dayaram: Not only subsidy fund, on bank loan also [banks are entitled to refinancing from NABARD on loans made to SHGs]. This is the great problem for developing the SHG concept. But here is most problem in India; everybody person will a subsidy. From bank and government and others, so many institutions. They want subsidy. And the subsidy culture is our Indian philosophy and others, this is subsidy culture. And our country below poverty line always they are, they have not land, they have not any assets. They want government will provide so many programmes and so many schemes with subsidy. They are, they don’t want to do it themselves, they want subsidy. And many groups are formed in our district for subsidy nature, and they are failure. Our organisation formed 22 groups, but we never say to him we provide to you subsidy, I am saying only and only you are upgrading yourselves. You are collecting some money and inter-loan, interlinking with each other. This is self help group! Than 22 groups is running very good.
- Monica: So your groups, they don’t, they have grading?
- Mr. Dayaram: First grading and second grading.
- Monica: But after first grading, if they don’t get subsidy, that doesn’t matter? They will still continue to save? Will they get bank-linked without getting subsidy first?
- Mr. Dayaram: They don’t need bank linkage, this is same the bank linkage when you open the account. You are linkage with them. But not necessary for you’ll take loan and you’ll take subsidy, is not necessary.

¹¹⁰ This must perhaps be seen in connection with what Mr. Dayaram stated a bit earlier in our conversation. He argued that it is not that the government does not have money per se, but rather that some of the funds tended to disappear on their way down the ‘chain of distribution’. For the poor people this meant that; either they would not receive the amount they were entitled to, or it could take a long time before the accurate amount was made available. The example he used was that the government (officials) argued that they had sent the respective amount; while the person distributing it to the beneficiary said he never received it (indirectly saying that the government does not have money as they never sent anything).

Competition does not only occur in terms of banks trying to acquire groups, or in terms of NGO's trying to expand their client base.

In the case of MFI sector, there are multiple levels at which competition has become a part of business environment. While competition is severe between the MFIs, there is also competition between MFIs and NGOs. MFIs and banks compete for clients in the same area especially in the more-developed geographies. ... Basically there are two areas in which competitive behaviour is witnessed. The first is that of client acquisition and the second is that of staff (Srinivasan, 2008, p. 85-86).

With what comes next, my aim is to raise awareness of the link I will suggest exist between excessive competition and the market failure 'imperfect information'.

The whole idea behind group lending is that it is expected to correct for the market failures that excluded poor from formal financial services prior to microfinance. We saw in chapter five and seven that group lending does not always translate into the full repayment of all loans taken, but it is nevertheless expected to somewhat correct for the lack of information banks used to experience to have about potential borrowers. I agree with this, but I will also suggest that even though a group lending approach is able to correct for some information imperfections, reaching poor through providers of microfinance have raised information concerns in new areas.¹¹¹ I will not argue that any of the following is a major problem in the microfinance sector as repayment rates in general are reported to be high,¹¹² but a tendency I noted during the fieldworks nonetheless, was that information imperfections in the formal sector now also relates to problems experienced by clients acquiring formal credit, and on behalf of MFIs regarding the 'loyalty' of their staff.

¹¹¹ This suggestion is made based on specific examples expressed by a few informants and secondary literature. In the literature we mostly meet similar stories to the once I am going to tell from the southern states, but as my informants expressed to have experienced and witnessed the same in many places in the country, this statement might apply to the sector as a whole more than what has been stressed till now.

¹¹² According to N. Srinivasan "discussions with Banks and MFIs as also customers of microfinance [in Andhra Pradesh] revealed that recovery rates of loan dues had fallen to around 85% on bank loans to SHGs even while MFIs posted high recovery rates of above 98%. SHGs covered under government's programmes had a comparatively bad repayment record. Without getting in to a debate on veracity of reported information and underlying mechanics of the recovery effort, the State's programme is seen to have come off second best" (Srinivasan, 2010, [online]). Singh states that: "repayments by members to SHG have been exceedingly high and on time. Repayments have generally been above 95 per cent" (2008, p. 118). And NABARD has published a document named *Progress under microfinance - highlights* on its website in which NABARD reports that: "On the basis of data reported by banks, out of 290 banks reporting the recovery data, 73% of banks have more than 80% recovery of loans to SHGs as on 31 March 2007" (NABARD, 2006-2007, [online]).

8.2 MFI staff changing loyalty

During the roundtable on the *State of the Sector Report 2010* in the Annual Forum N.

Srinivasan wanted the group to address the challenges the participants had witnessed with regard to Human Resources in the sector. He opened the discussion by saying that: “In the sector we are facing a lot of difficulties in maintaining the talented people. People are also committing some fraud, and take away the groups also, when we take some disciplinary actions they go away with the groups, so we are facing lot of problems in the field.” One of the participants offered his view on the statement by arguing that:

In the beginning of the MFIs, in their start ups, the staff get's more incentives. Once the operation is in place, after eight months, nine months, the incentives are dried up, because there are no more customers. Basically the incentive part is a bigger part for their salaries, so after nine months they try to find another MFI which is going to open in the area, or they want to jump to the next level, the branch manager, this is the problem. This is a problem in all sectors, this not only a particular problem of MFIs, but only the thing is that the client relation is so much weak from the organisation to the client. Only the person who has formed the group, he is only the contact person. Even the branch manager does not know who are the clients. So when he leaves [the person who formed the group], the problem is starting to come up.

As an employee shift from one MFI to another, not only does he take with him the knowledge of the internal workings of the former MFI, but he might also take the client base he has established. In accordance with the concern raised above, staffs working directly with clients are the only ones who intimately know the people in the groups they are responsible for, and they therefore have the advantage of using this familiarity to shift the clients' loyalty. New MFIs entering an already occupied market might be motivated to hire staff willing to bring with them an already established (and trained) client base, as this will lower the MFI's start up costs. This again, might very well affect the likelihood for strategic default among clients. If clients are guaranteed a new (larger) loan elsewhere, and the person in control of their account with the former MFI will not inflict penalties upon them, the clients' incentive to pocket the money they have borrowed is strengthened. This will also affect clients that had no intention of changing MFIs in the first place as they know that they (in theory) no longer will be eligible for new loans from the initial MFI unless they are able, and willing, to repay the debt of runaway group members. One more issue working against the former MFI in such cases, is that the employee is likely to shift loyalty during the first year or so (if we are to rely on the quote). This means that the group's savings is not yet very substantial, so the incentive to stay might be lower than if the group had been together and pooled their savings for several years (in cases where the staff is unable to transfer the savings to the new MFI). If the revenue

from pocketing loans (and maybe sharing them) is bigger than the loss of savings, odds are that some clients, or maybe whole groups, will be tempted to go with the employee changing MFI.

8.3 “Earn with the mind, work with the heart”¹¹³

As a group of us participating in the Annual Forum sat down for dinner the three gentlemen sitting next to me initiated a conversation about why and how all of us had gotten engaged in microfinance. One of the men used to be a journalist concerned with social injustice and said he felt the need to take some hands on action in trying to improve the lives of the people he had met with and written about. Another believed it to be unfair that he should have access to pension and bonuses in old age just because he was born lucky while so many of the hardworking people he interacted with during the day should not just because they were too poor to be included in the formal economy. He wanted to do something about that. I replied that I believed the concept of microfinance to be a tool that, when applied well, could help a lot of people in distress to improve their realities, and that I hoped to become a part of that movement one day. We all turned to the fourth man and (I at least) expected some kind of emotional or idealistic answer, but when he looked up from his dinner he said: “I’m in it for the money. Obviously, people need money to live, I need money.” The former journalist smiled at him with this kind of half laugh and asked: “But you do believe in helping people? Or why else are you *here*?” The fourth man looked at him seemingly surprised and replied: “What do you mean? The organisation needed somebody to go, so it was my job to come here. Before I used to be an X, but when they offered me better job here, I took this one.” I stopped eating. It felt like the atmosphere in the room changed. The man who had initiated the conversation immediately began to account for all the great things that could be realised from microfinance. The former journalist looked at me; he raised his eyebrows and shook his head before he turned back to his dinner. I just sat there with my mouth half opened.

What I am trying to say by retelling this story is that it is quite normal that people chose to change workplace if they get offered more money or better terms elsewhere. This statement might be the most obvious one I will ever make, but had you experienced the change in mood, seen the resentment in the eyes of those witnessing the fourth man’s replies (including in my eyes I assume, because I did feel it), or heard the disappointment in the

¹¹³ One of the men attending the roundtable during the Annual Forum so elegantly put it this way when we discussed Human Resources in the sector of microfinance.

voices of the people talking about how disloyal staff change MFIs just because they want more money, you would know that a lot of us have forgotten how obvious this fact actually is. I assume that this is connected with the mentality expected to operate among all persons working in sector of charity, or aid. Whether you are employed by Doctors Without Borders, Save the Children or The Red Cross, people are likely to assume that you are in that particular line of work because you want to help other less fortunate people. Microfinance is somewhat connected to this line of work as it focuses on assisting the poor, especially the most deprived and thereby also mainly women. Dr. Yunus (who has become the representative for microfinance worldwide) won the Nobel Peace Prize for his efforts to extend formal finance to the unreached, and India's government has focused on providing microfinance through the country's banks as part of its attempt to alleviate poverty. It is not hard to see where people might get mixed up, where I got mixed up, but microfinance is not charity, it is business. It is about extending financial services and expecting to profit from them. It is ('just') about providing the poor with the same services (though on worse terms) that the non-poor access. Yet, it is not fully perceived as an ordinary business, it is not an ordinary business, it is a mix of business and (sustainable) aid. It is in this mix, I believe, that the problem arises.

Some begin to work with microfinance because it is the best job available at the time, others might experience that microfinance has found its way into their line of business. Imagine a banker, he might not have any particular interest in microfinance nor care too much about the deprived women in his community, but when an SHG walks in the doors to his office he nevertheless provides that group of poor persons with financial services. A man working hard to form groups of women, coach them and interact with them on a weekly basis might also do so just because he gets paid extra per group he forms. At the other end of this scale you find the people that have devoted their lives to assist the needy. Some have found microfinance to be the best tool through which they can do so, and they care deeply for both the clients and the approach(es). They will probably try to learn as much about the sector as possible, and try to improve whatever flaws they encounter. I suspect that you will find these people, with a deep personal engagement, quite high in the respective organisation or institution because a personal commitment often entails that a person will work hard to realise whatever scenario he or she dreams of. This might involve going to school and becoming a researcher, advisor or spokes person for the sector, or it might mean that a person will work his way to the top just so he can have a say in the institution/organisation he is associated with. Such persons might be the founders of an organisation, or for example the people

inviting you to a three days forum on microfinance so as to enable all the other ‘devotees’ to meet, exchange ideas and experiences, share problems and seek solutions. But when the people at the top of this pyramid goes in the trap of believing that all people working with microfinance are just as engaged in it as they are, the whole working of markets seems to get a bit neglected. That a lot of the people engaged in providing microfinance are idealists does not translate into that the providers are unaffected by competition. The actions taken by staff of microfinance providers (often a direct result of intensive competition) is what makes up this new imperfect information paradigm (new in the sense that strategic default used to be a result of a customer’s own choice, while now persons in the formal credit providing chain might ask/tell a poor client to do so).

The problem might be, as I see it, that the microfinance sector has become too reliant on individuals, or more exactly, the individuals at the bottom of the providing pyramid, the ones handling the clients. I will suggest that it is also amongst these people that you tend to find those who work with microfinance just because it was the best option available to them at a given time.¹¹⁴ Had all providers of microfinance truly been aware of the quality of the link between the organisation/institution and the borrowers, they would have worked actively to find a way to tackle the problem of staff running off with clients. They could have provided some incentives which lessened the temptation drawing staff to new institutions, or drawn up contracts that hindered staff from running off with the client base they had established. But this does not appear to be the case; employees are able to run off with formed and trained groups, and the practitioners and researchers at the Forum did expressed a concern with regards to the Human Resources in the sector. If the provider is new, and/or small, having only seven people working to promote groups, and three of these decides to change employer, the institution runs the risk of losing almost half of its clients. This can very possibly affect its sustainability as the institution most likely has borrowed the funds it lends out somewhere, and this money will have to be repaid. If the institution should survive, more money or more debt is infused in it, interest rates are likely to be raised in order to compensate for income lost, wages would probably be cut back on, and the pressure on the remaining staff is likely to increase, as will the pressure on, and supervision of, the clients. Based on this I will argue that

¹¹⁴ Please note that I do not include all staff of all the providers of microfinance when I write this. A lot of people, regardless of their position, works in the microfinance sector because they wish to do exactly what they are doing, and they believe that what they do can help others. There are also some leaders of organisations or institutions, scholars or policy makers that do what they do just because it is good money to be made from doing it. As I stated above, this might not be a great problem in the sector due to the relatively high repayment rates that are reported throughout it, but it is nevertheless a problem, possibly becoming a development, which I believe needed to be addressed.

it is important to create a stronger link between the organisation/institution, staff and the borrowers, and that this link does not yet receive proper attention.

8.4 Financial inclusion

It is due to the fact that people now believe it to be worthwhile and profitable to supply the poor with financial services that the outreach of microfinance in India has become as great as it has. In certain cases though, the people believing in the concept are not the same as the people actually providing the services, the people setting the targets versus the people expected to reach the targets. We will now turn to address how some of the people argued to be financially included (targets being reached) still lack access to formal financial services. As this is a thesis on microfinance and outreach, I wish to once again point out that the argued outreach of the sector as a whole (narrowly defined) counts 76.6 million clients (before adjusting for potential overlaps), whereas that the broadly defined microfinance sector had more than 135 million clients by the end of March 2008. We have already seen that the sector, narrowly defined, counts more accounts than the number of poor households in India (between 61 and 63 million households), correspondingly we find that the number of accounts reported in broadly defined sector more than double the number of poor clients.¹¹⁵ According to the *State of the Sector Report 2009* (p. 2) the number of low-income households in the country is about 130 millions, however, through e-mail communication the author of the report expressed that: “130 million low income households refer to \$2 per day PPP level in 2001. As per more recent estimates, by 2004-05 this has increased to about 160 million households.” (E-mail communication with N. Srinivasan, 09.05.2010). This means that even if we were to discuss the outreach of the sector in comparison to all low-income households in India, microfinance still show a sizable outreach.

If providers of microfinance actually direct their services to poor and even low income persons, the financial inclusion of these segments seem well on its way to becoming realised. So why is there still such a large dependence on informal lenders in India? How can NSSO data reveal that despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (C. Rangarajan (chairman), 2008, p. 2, [online])? We found in chapter six that the size of the loans can account for some of the discrepancy in respect to the informal sector, and following I will introduce one more factor; holding a bank

¹¹⁵ See the introduction to this thesis for references, definitions and calculations.

account, hence being included in the formal economy, does not necessarily translate into that the client has access to formal financial services.

8.5 What does it mean to be financially included?

When I came home from the Annual Forum and went through my notes I found that I had written down and underlined the following sentence (though formulated in a number of ways) on seven different occasions: “Ghost accounts are not clients!” This represents that I on seven different occasions, during a forum lasting only three days, heard somebody argue that the financial inclusion in India was of a poor quality. According to *the State of the Sector Report 2009*, RBI commissioned studies on the quality of the financial inclusion in several states and the studies reviled that inclusion levels were neither high enough to claim success nor was the effort sustained long enough to ensure that new clients actually used the facilities available. One study found that in Cuddalore (Tamil Nadu), a district that the State Level Bankers Committee had declared 100 per cent financially included, 25 per cent of households still remained excluded after full inclusion had been declared. According to the bankers this was due to the clients’ unwillingness to use the use the facilities (Srinivasan, 2009, p. 115). N. Srinivasan extracted the following passage from the report:

The team randomly selected some households within 1 km. distance from the branches to find out the reason for unwillingness. Everyone agreed that the signature on the survey form was theirs. But they were not aware that those officials who carried out the survey came for opening a bank account. They said that the surveyors had asked for their ration card and filled details from it without informing that they could open a bank account. They signed the survey forms thinking that the process was for some government scheme that would come in the future. It is therefore premised that the unwillingness was on the part of the bank to open the accounts rather than the other way around (Srinivasan, 2009, p. 115-116).

Srinivasan continues by showing that 72 per cent of the new accounts still had zero or near zero balance after one year, and that an additional eleven per cent had a balance of less than 200 Rupees and at least one transaction during the year (Srinivasan, 2009, p. 116). After accounting for quite a number of similar discrepancies between argued outreach and actual financial inclusion in India, Srinivasan points out that opening of accounts seem to be the sole criterion on which performance is measured. “Once the account is opened, it is deemed that the goals of inclusion have been realised” (Srinivasan, 2009, p. 116).

During the bus ride to visit with Aapni Sahakari Sewa Samiti Ltd. during the Annual Forum, Mr. Rajeev Deshpande offered his view on financial inclusion:

So, presently the Indian banking system does not permit poor people to bank. Even if I send some people to open an account in banks, banks don’t find time to open their accounts. That is the ground

reality, big banks, public sector, private sector, they don't have time to do the account opening. Public sector bank compulsions have to open certain amount of accounts, but only out of compulsion they open. Out of anxiety, out of interest they don't open.¹¹⁶

Among the participants at the Annual Forum, it was widely agreed upon that just opening an account by no means constituted financial inclusion.

One thing became very clear to me [from this discussion], the idea that inclusion means involvement of the banks, direct involvement of the banks is not applied. ... As we see every day, all these years, the cultural compatibility between the formal banker and the poor is very low. It will build up over a period of time, I understand, but we know that formal banks are hesitating, so we should make strong recommendations. ... You can always say that even in a loan of 500 Rupees it is not inclusion. Minimum somebody needs is 5 000 Rupees, 10 000 Rupees or 20 000 Rupees, first than we say, yes, they are financially included. Instead of just opening a passbook and not having any transactions.¹¹⁷

Another participant argued that: “Unfortunately RBI view inclusion as an end in itself, that it is a thing that has to be achieved in a three years time. Inclusion cannot be an end in itself, it's only the process.”¹¹⁸ Viewing financial inclusion as the ultimate goal, and not paying attention to the quality of inclusion, opens for a gap that might be filled with ‘ghost accounts’. A person cannot be said to benefit from having access to formal financial services when he does not know that a bank account has been opened in his name. As long as no transactions are being made, and there is little or no money deposited into the account, I will, like the people quoted above have, argue that financial inclusion is not taking place. Based on the testimonies of my informants and the literature familiar to me I cannot say how large the scope of this phenomenon is. It does certainly not apply to the entire range of clients that is argued to be included in the formal economy, or to all banks, but I am under the impression that the number of accounts that merely exists in terms of numbers might perhaps be significant.¹¹⁹

8.6 Clients experiencing imperfect information

As providers compete over clients, a new information imperfection has gained relevance in regards to poor people accessing formal loans. Clients now experience to be led astray when it comes to the cost of borrowing. In the informal credit market the cost of borrowing has

¹¹⁶ Jaipur, 25.06.2010.

¹¹⁷ Expressed during the thematic workshop on Policy initiatives, programmes and projects for financial inclusion the first day of the Annual Forum, Jaipur, 23.06.2010.

¹¹⁸ Expressed during the same thematic workshop, Jaipur, 23.06.2010.

¹¹⁹ The assumption is further strengthened by the fact that quite a few people merely lend out their names against a fee allowing others to form groups ‘with’ them, or taking loans in their names (which we addressed in chapter seven).

mainly been a result of the negotiation between a client and his patron, while in the formal sector interest rates have been more regulated as the Reserve Bank set a maximum percentage that banks can charge on credit. The newness of this market imperfection should be seen in light of greater access to formal finance amongst the poor, but the fact that interest rates on formal finance now is left almost entirely to the discretion of the provider in cases of MFIs, is nonetheless a new information imperfection that needs to be addressed.

Based on “*Microsave’s Focus Note 8*” by Graham Wright, N. Srinivasan states that the consequences of the competition are that clients will be more demanding and will apply their freedom to choose MFIs according to their personal comfort (Srinivasan, 2008, p. 87). But according to Mr. Nair, the director of the NGO InSET India (Initiative for Social & Economic Transformation), the reality does not always reflect the presumption.

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|-----------|--|
| Monica: | But as there are many MFIs operating in this area, why don’t clients just shop around for credit? |
| Mr. Nair: | There is no strict evaluation of the MFIs in India by the government agencies. That is why, in my coming presentation, I am proposing that as one of the points actually. You will see from that, everything is clear, because there is no strict evaluation in India there is no transparency available, so they can do whatever they do. |
| Monica: | But the clients, if I go to you and you say I pay eight per cent, and I go to another guy and he says 56 per cent, than I will go to the cheapest guy? |
| Mr. Nair: | But there is a gap in the information. Poor fellow, I am the borrower, I don’t know whether money is available at cheaper rate of interest. |
| Monica: | But if it is a small village with two MFIs operating in the same village, one cheap and one expensive, all the villagers talk to each other, don’t they? They will know that these guys are no good. |
| Mr. Nair: | Actually, the agents are doing it. If you give me at the rate of 12 per cent, you tell me very privately: “Mr Nair, don’t tell I am giving you loan at 12 per cent. You say I am giving out loan at 36 per cent.” So the poor fellow knows only 36 per cent he is giving. Actually, this is very cheaty. |
| Monica: | This is common? |
| Mr. Nair: | Many MFIs are applying this, therefore we are trying to bring out a law to regulate them actually, so whatever being charged should be known to the government, through their annual report or their balance sheet. |

As we can see from conversation with Mr. Nair’s, the freedom to choose MFI according to personal comfort might not reflect that clients are in a position to take advantage of the competitive environment and thereby access to the best services that the MFIs have to offer due to this ‘new’ information imperfection. In worst case scenarios this results in excessive interest charges by the provider (or the staff), and it is these rates (demanded in the ‘cheaty’ way or merely shielded from the public eye) which presently is causing all the commotion with regards to poor people becoming debt slaves due to microloans. Mr. Nair also advocates the need for a law to regulate the MFIs, and during the Forum he was not the only one who

did that. We will discuss the need for such a law, as well as the reactions that came against the state government of Andhra Pradesh (AP) when they recently decided to regulate the MFIs in the area, in the last part of this chapter. First we will turn to explore the most well-known outcome of competition, multiple lending/multiple borrowing. Excessive competition, and there from multiple lending, is typically associated with a few southern states.¹²⁰ I aim to show that multiple lending is in fact a rather large phenomenon that is not only restricted to these areas, which furthermore implies that the argued outreach of the microfinance approaches in India is likely to be overestimated.

8.7 Multiple lending, are repayments real or myth?

In the *State of the Sector Report 2009* N. Srinivasan points out that MFIs report client data which can be overlapping as customers sometimes borrow from more than one MFI in areas where competition is intense. He argues that overlaps also exist between banks and MFIs in case of SHG lending, and that multiple membership of SHGs can be another source of potential overstatement of client numbers (Srinivasan, 2009, p. 21).

This report being one with a tight deadline, does not (and cannot) research in to the issue; but points out that overlap of clients between SHGs and MFIs and multiple loans by same individuals and households is a factor. Some adjustments for the overlap is made, but I would not say that it would be statistically satisfying. Even in case of MFIs multiple borrowing clients is rampant in some states. I am hoping that some studies would be available this year to get a fix on this and provide a better basis for computing the penetration of microfinance (Email communication with N. Srinivasan, 09.05.10).

During the round table on the *State of the Sector Report 2010*, multiple lending naturally became a subject of discussion. N. Srinivasan then pointed out that: “If you recall, last year’s [report] Andhra Pradesh shows that for each poor family there are eight accounts.” The statement clearly indicates that multiple borrowing is happening, at least in Andhra Pradesh, though the number should be seen in light of non-poor being able to take advantage of the services provided by microfinance practitioners. The Kolar experience (in Kerela) came about (partly) as a result of a borrower having managed to accumulate a *microloan* debt amounting to 0.7 million Rupees, also a clear example of multiple borrowing.¹²¹ But if we are to accept

¹²⁰ “The four southern states (AP, Tamil Nadu, Karnataka and Kerela), with 20% of India’s rural population, account for 54% of SHGs and 75% of SHG bank credit” (Sinha, et al., 2009, p. 4-5). “The microfinance penetration index shows that the gap still exist in the Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh (BIMARU) states and northern region. ... The intensive coverage of microfinance in Tamil Nadu, AP and Karnataka needs greater in-depth study and analysis” (Srinivasan, 2009, p. 4).

¹²¹ To learn about the Kolar incident please see: *Microfinance India: State of the Sector Report 2009*, (Srinivasan, p. 8, 71-72). For a report that explores what went wrong in Kolar and the spinoffs it had to nearby

that multiple lending/borrowing mainly is a result of intense competition, it should be legit to argue that this is not a very common phenomenon in comparatively ‘low competition’ areas such as the northern belt and hill areas. The experiences I made during the fieldworks however, contradicts this assumption as many of the people I interacted with, and/or interviewed, raised a concern that there might be more bubbles waiting to burst in other parts of the country as well.

In Uttarakhand Mr. Kunwar expressed his concern in the following manner:

Everybody is making SHGs, so some times, what is happening is that one SHG is countered by four departments. ... At the moment we are in a very confusing state in Uttarakhand, one member is member of three SHGs. One SHG of this department, one of that, there are different schemes. And you have same people in the village. What to do? By three names and three places the same person is there. I think this is the confusion for the people making the schemes, in the top. There is a lack of coordination amongst the departments.¹²²

From Rajasthan, Mr. Dubey told of similar happenings during the roundtable on the *State of the Sector report 2010*:

Last week I got an offer from one MFI. They were running two branches in Rajasthan and they asked that whether I could take over their clients because they don't want to operate in Rajasthan. So I asked my assistant to go and visit that. ... Out of out of 200 clients, they were having only 200 clients in three months, 60 clients were already from our! And I heard 20-30 were under the CRT[?] and JRT[?] or what so ever, so I was not able to take those clients, because I see the situation is going to come, if the merger is going to come, the same clients would have been taken five loans from one MFI.

To lay emphasis on the quotes above, I find it fitting to include what one of the other participants at the roundtable bursted out with after Mr. Dubay had finished his story: “In Statmaggar we call it a payback scheme!” The mere fact that northern state microfinance practitioners have nicknamed multiple borrowing ‘payback scheme’ rather clearly reflects that clients have (easy) access to multiple loans outside the southern states as well.

There is a clear link between multiple borrowing and the question; why do people choose to borrow from multiple sources? The answer though, is many folded and does of course vary with individual needs and preferences. Some take multiple loans because they are easily available, some get pressured by family members or authority persons in the village to borrow, some are not actually borrowing but merely lending out their name against a fee, others again might be bound to approach multiple sources as the size of one microloan is

towns see: “Competition & Role of External Agents” by the Association of Karnataka Microfinance Institutions (AKMI), 2010, [online].

¹²² Kaleshwar, 26.09.2009.

inadequate to cover their needs. In need of raising larger amounts (from the formal sector), multiple borrowing from providers of microfinance has become a well know option to the formerly unbanked clients.

With regards to this multiple lending, I have some perspectives I want to share. During one of my field visits I was visiting a grocery shop in Madhya Pradesh, and I started interacting with that one person, she had borrowed from five sources. This has happened some two years back. Then I asked; why you have taken five loans from different players? [She said] “Sir, my requirement is huge, because I need around one lakh [Rs. 100 000] working capital, but these people are giving only term loans which I need to repay immediately, than I cannot maintain my stock. The nature of fiscally offered is also not suitable for me, and the amount also is not adequate for me. So if somebody comes from single source and gives me, I am ready to take it.”¹²³

As we have already discussed the size of microloans, I will not address it any further here, I merely wanted to include the quote as it reflects the connection between the size of loans and multiple borrowing. Moreover the example will work as a reminder to that the AP Ordinance, which will be discussed briefly, might cripple the possibilities poor people have of working their way out of poverty by restricting them from borrowing from multiple formal sources. The conversation additionally took place in Madhya Pradesh which further indicates the outreach of multiple borrowing/lending. The above quotes, none of them from the areas in which competition assumingly is intense, implies that the argued outreach of the microfinance sector can be overestimated even after some adjustments to the numbers has been made.

Providing borrowers with multiple alternatives for credit might contribute to undermine the repayment discipline of borrowers as it enables them to juggle between the different providers, repaying one loan with another, or defaulting with one while retaining their relationship with the next. One of the participants at the Annual Forum argued that people having borrowed from multiple sources put a lot of consideration into creating a repayment schedule that (barely) allows them to have continued access to formal finance:

They usually repay one institution this month, thinking that I will not repay this one this time, because they need to pay the other one. Next month I have to pay this one, than I pay that one next time. It is actually lots of overdue, you know! Taking different loans for different purposes, they are continuously in debt. It is very time consuming. If they could only have gotten everything from one, they would be free of the headache of repaying and borrowing from all the different MFIs.¹²⁴

One more example of this can be found in the quote of Mr. Dubey in the former chapter: “they have the back to back centre meetings.” During the roundtable on the *State of the Sector*

¹²³ Stated during the roundtable on the State of the Sector Report, Jaipur, 23.06.2010.

¹²⁴ Expressed during the bus ride home from visiting with Aapni Sahakari Sewa Samiti Ltd, Jaipur, 25.06.2010.

Report 2010, Mr. Srinivasan asked the participants whether they were under the impression that clients successfully juggled various loans, or if they believed it to be a sign of distress. To this Mr. Dubey replied the following:

Once you go and see the delivery of the loans, and the receiving of the loans, this is over a period of time. Second thing is that when money is in the hand, people can't keep for long to repay the money loaned, either that would be utilised into consumption, or, if not, would go for the productive purposes. So, that's why I am convinced, somewhat, that we have to see the cycle how loan is coming to that group, first, and what is the use of that money. Rather than saying that one person is taking loan from one institution and repaying that one other person loan. But always there is scarcity of the money, so it cannot go long. If it is continuing for last three years, I don't see that this is going to go more than four year, five year.

If clients are unable to utilise loans efficiently, to generate the required income to repay their total debt, default will occur. In the beginning it might be relatively easy to keep up the juggling, which can make it harder for the institutions to see the warning sign until it is too late unless other clients come forth and tells on the potential defaulter. This again, depends on whether or not the other group members also have borrowed from multiple sources, and on how well they know the potential defaulters situation. Either the potential defaulter is able to borrow more money and keep juggling until he by some means gets the money to repay all the loans he has taken, or he might choose to repay only one of the institutions and in that way at least hope to maintain his relationship with that agency. One person pocketing three loans might nevertheless mean that three SHGs (60 people) risk going unfinanced, that these people will be angry and possibly take action, and that the three institutions he defaults with will do everything in their power to redeem the money lent.

Multiple lending/borrowing becomes a problem when clients accumulate more debt than what they are capable of repaying. Not being able to repay is likely to impose hardship on the poor borrower in terms of physical and/or verbal abuse from the lender, other group members or even give the defaulter a bad reputation in the community at large. Some lenders will also take control over the defaulting borrower's assets in order to cover the amount outstanding. A person who is unable to repay runs the risk of destroying the credit worthiness of an entire, or multiple, groups of people. As we saw in chapter five, people experiencing repayment problems might become subjects to strict surveillance by others to the extent that the household's entire expenditure pattern is vigorously monitored by a group (leader) or the lender, and the harassment of defaulters has allegedly become so harsh in some areas that poor borrowers have begun to take their own lives due to their microdebt.

8.8 The gap between implementation and self-regulation

The overriding objective of microfinance is to provide poor persons with services and products that can help them cope with everyday factors of stress and concern. Guided by this ideal, most providers of microfinance are fairly free to choose who they direct their services at, the range of products they deliver and the requirements they set for delivering these services. In case of MFIs, even the cost (interest rates) they place on the clients is left to the discretion of the provider.¹²⁵ This freedom is to a certain extent resulting from the lack of a monitoring agency that controls the procedures in the MFI approach. The lack of a monitoring agency is also contributing to (the problem of) multiple lending. The only way an institution can know if an applicant is free of external formal debt is to trust that the client or his peers will tell whether or not there are any loans taken elsewhere, or if institutions working in the same area by their own will choose to exchange client information.¹²⁶

On the first day of the Annual Forum I attended a group discussion (theme based workshop) on 'Credit'. As one can suspect, discussing credit brought up the issue of an insufficient regulatory framework. I have decided to retell some of what was being said in the form of a summary of the discussion. The summary is complemented with quotes from the participants to put focus on the points I have found to be most relevant for what we will discuss below. The statement that initiated the following part of the group discussion was: "At present, the microfinance sector in India is not regulated, unfortunately." A couple of people immediately contradicted this. They argued that there are policies meant to regulate the dealings in the sector, and although nobody denied this, the majority of the participants argued that the policies were no good as they were not implemented. A man argued that there is a loophole though, moral suasion. NABARD or the RBI can step in and exercise this moral suasion when the self-regulation is not being complied. But according to another participant moral suasion does not carry any way; "Sa-Dhan"¹²⁷ has circulated this 'Code of Conduct',¹²⁸

¹²⁵ Banks, at least, needs to keep costs within the regulatory framework set by the RBI.

¹²⁶ During a theme based workshop I attended during the Annual Forum we discussed the likelihood for MFIs willingly sharing their client lists. One man argued that the MFIs should be motivated to share client information as they themselves ultimately would be the losers if multiple lending resulted in poor quality groups and increased possibility for defaults. The idea was welcomed by the group, but we recognised that it would be difficult to implement this. "Who will give you the data unless you have the authority to collect it?" "Data is my life line, as an MFI this is my lifeline, why will I give it to you?" "Here, this is my clients, please don't lend to them" (Jaipur, 23.06.2010). Furthermore there is an ethical dilemma, is it fair to expose clients' lives like that?

¹²⁷ "Sa-Dhan ('The association of Community Development Finance Institutions') set up by micro-finance organisations (MFOs) in India" (Fisher and Sriram, 2002, p. 36).

¹²⁸ The "Code of Conduct" refers to principles, values, standards, and rules of behaviour that Sa-Dhan has suggested should guide the decisions, procedures and systems of MFIs. The suggested "Code of Conduct" can be

for quite some time now, and Sa-Dhan is a network of MFI associations themselves. If this group itself does not follow this, than what is the point of asking somebody else to come and tell what needs to be done, say that this is the moral suasion, do it yourself?” “The Indian expectation is that self-regulation does not work out, at all. We people tend to, if there is a rule some are not even willing to follow, but if there are no rules, we are definitely not bothered at all.” “Let’s not call it moral suasion,” a man responded, “call it a formal regulation, then there is a threat, where is that in Sa-Dhan?” The topic under debate turned towards who should have the responsibility of writing down these formal regulations, and who should make sure that they were followed. “The whole stick with the Reserve Bank is that they will move out of private sector lending and then the funds, or the tap, will be closed. As simple as that, public sector bank window will not be open. That is the threat RBI uses short of the regulations.” “Yes, I am not denying the policy, but the warning should be a formal regulation, and then you need an Act.”

As many have before us, we began to debate the need for a regulatory Act. This is nothing new; the need for an Act has been discussed for years, as have the suggestions of what should be written in it. “Act has been holding flat for last hundred years! [Everybody laughs, and the man corrects himself] or the last three years, but it just doesn’t seem to move.” According to one of the participants though, it just had. He said that in the Pondicherry conference he had attended it had been decided that NABARD was going to be regulator of the MFIs. This did not sit well with quite a few of the participants, and the debate ran hot. Everybody was speaking in each other’s mouth, not agreeing on whether or not NABARD should, and would, become the watchdog in the MFI sector. After a while the ‘Rapporteur’ Mr. Ratnesh took the word. He wanted to sum up what we had discussed so as to prepare the presentation that would be made for the rest of the participants at the Forum the following morning. “Can I than safely assume that I am speaking for the group when I say that microfinance bill, which has been hanging by for quite some time, needs to come in shape, needs to be implemented. First than we will realise its shortcomings, because you see, everything is in the draft form, how do you react to a draft unless you know what kind of annual it is going to generate?”

read in full on the following link: <http://www.sksindia.com/downloads/sa_dhan_core_values.pdf> (Sa- Dhan, (date not available), [online]).

Only a few minutes prior to the workshop I had been discussing the lack of a regulatory framework in the case of MFIs with Mr. Nair. He did not participate in the group on ‘Credit’, however he had reflected over the subject.

- Mr. Nair: See, one is, there is already regulations. Other is implementation. You have a law, but you are not implementing in a proper spirit. What is the use of such kind of law? The implementation is very poor in India. Government may be saying that this is the maximum interest you can charge, but, implementation side is very poor, so the public do not know, the government does not know how much per cent a particular MFI is charging.
- Monica: What is the regulation, do you know? How much are the MFIs allowed to charge?
- Mr. Nair: Regulations knows, but again, this is bribery system. The government official takes money, cover up the story and don’t issue the information to anybody.
- Monica: But in theory, what is the interest charge for MFIs?
- Mr. Nair: See, normally government fixed is 12 per cent, but they [MFIs] are charging more than that, because if you want to run the organisation for 12 per cent interest you won’t be able to manage it actually. An independent department or an independent ‘watchdog’ to see if the rules and the regulations are meticulously and rigorously followed by MFIs is needed.
- Monica: Who should be that watchdog?
- Mr. Nair: Government itself.
- Monica: Government itself, but if the government is corrupt than?
- Mr. Nair: No, as a whole government is not corrupt. The people working in that, the bureaucracy working in that, the staff working in that.
- Monica: But won’t the staff working as watchdogs also maybe, possibly?
- Mr. Nair: See, normally watchdogs are not corrupt. People working under the watchdog are corrupt. The agency might not be corrupt, but the clerk attached to the judge might be corrupt. That is what happens in India.

In accordance with the statements of my informants, the lack of an (implemented) formal regulatory framework for MFIs has gained much attention from both clients, scholars, journalists, practitioners and policy makers over the last few years.¹²⁹ The problems of having an unregulated sector relate, on behalf of clients, to who is being reached, how many times each client is being reached, and at what cost to the client he is being reached. In the media, the focus has mainly been on the exorbitant interest rates (resulting from a lack of transparency in MFI practice as well as an unwillingness, or incapability, to follow the suggested ‘Code of Conduct’) that MFI allegedly charge, and how these drive poor farmers into take their own lives. Andhra Pradesh (AP) is the state in India that has gotten the most negative attention both from Indian news papers and from abroad.¹³⁰ The accusations against MFIs resulted in the passage of an Ordinance by the State Government which was

¹²⁹ This escalated after the conflict between the State (Andhra Pradesh) and the MFIs reached a fever pitch in 2006 when district authorities closed down about 50 branches of two major MFIs in the Krishna district after allegations of usurious interest rates and coercive loan collection (Shylendra, 2006, p. 1, [online]).

¹³⁰ Only a week ago I read an article on farmer suicides in AP due to microfinance in the Norwegian newspaper *Aftenposten*. The article was named: “Ba om smålån, ble gjeldsslaver,” translated into English that means “Asked for small/micro loans, became slaves of debt.” (Østgårdsgjelten and Harbo, 2010, [online]).

promulgated on October 15th 2010. Even though regulations have been requested for quite some time, critical reactions to the ordinance came about immediately after it was broadcasted (and in my view for justifiable reasons). In the Deccan Chronicle on October 21th 2010, one could read the following:

In another blow to the micro finance industry, banks have halted disbursements of sanctioned and approved loans to companies operating in the sector. The development was confirmed to this publication by industry sources who refused to be identified given the sensitive nature of the development.

Earlier, these firms had been barred by the Andhra Pradesh government from collecting their dues till they were properly registered as mandated by a new ordinance. On Friday, the Andhra Pradesh High Court is scheduled to hear the petition of the micro finance institutions against the ordinance. According to industry sources, banks have already stopped the disbursal of around `175 crore to `200 crore to around 44 MFIs this week because of the stalled recovery of micro loans from MFI customers in Andhra Pradesh (Deccan Chronicle, 2010, [online]).¹³¹

In response to the discussion ‘A National Regulatory Framework for Microfinance Sector’ (from the email based Solution Exchange platform I introduced in chapter five) I have, just during the last week, received the two articles: “Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?” (An Intellecrap White Paper, 2010, [online]), and “Is Micro Finance leading to a Macro Mess, The AP Ordinance” (Fernandez, 2010, [online]) as well as 13 web links to some of the recent posts (blogs and articles) which address the situation in AP.¹³² I have yet to come across, or more correctly to receive, a publication which is not somewhat critical to the ordinance.¹³³

The Ordinance (‘Andhra Pradesh Micro Finance Institutions (regulation of money lending) Ordinance 2010’) is, according to the Intellecrap White Paper (2010, p. 2, [online]), built on four premises:

¹³¹ One crore equals ten million.

¹³² For those who wish to read more about the situation in AP, the posts can be found on <<http://microfinance-in-india.blogspot.com/>> ([online], 17.11.2010).

¹³³ It should be noted that the ordinance has only been in working for about three weeks as I write this, and that I have not prioritised to find any publications praising it either due to the time that is available to me before this thesis is due, ergo ‘received’. I do nevertheless feel that it is justified to argue that the ordinance have some obvious flaws which, in my view, contributes to weaken its status. For example: “The definition of Microfinance Institution as it stands in the ordinance includes banks, and even SERP [the Society for Elimination of Rural Poverty which is an autonomous society of the Department of Rural Development, Government of Andhra Pradesh] and its federations as these entities are either ‘providing loans to low income clients or offering financial support to them’ [though it does not apply for banks, SERP, nor their federations]. The definition of low income client is not available either in the ordinance or anywhere else. This leaves wide scope for interpretation. The requirement of display of interest rates does not define ‘interest rate’. Whether flat rates, monthly rates and other confusing rates can be displayed?” (Srinivasan, 2010, [online]). From the following discussion on the ordinance’s regulation of multiple lending/borrowing it should furthermore become clear that it might be beneficial for both clients and the MFIs if the national level Act came into working within long.

- a) MFIs charge usurious interest rates;
- b) If clients fail to pay on time, MFIs use coercive methods to collect the interest;
- c) These practices are forcing the poor to commit suicide;
- d) MFIs make huge profits and have no social mission to help the poor.

The Intellecrap White Paper further argues that:

Through its allegations, in the extraordinarily-phrased Preamble, the Ordinance strongly suggests government dissatisfaction with, and even broad antipathy towards, the entire MFI industry. However, these premises may not tell the whole story. With the fullest respect, it is possible to read into these allegations signs of a state government unhappy that its programs (and perhaps the individual influences of some members of government) are being undercut by the MFIs (An Intellecrap White Paper, 2010, p. 2, [online]).

This might especially be seen in the fact that the ordinance makes it mandatory for all private institutions engaged in micro-lending to register (and specify their areas of operations, their procedure and so on) with the district Registering Authority, the Project Director of District Rural Development Agency (for rural areas), while granting the Registering Authority the power to “at any time, either *suo moto* or upon receipt of complaints by SHGs or its members or by members of the public cancel the registration of an MFI after assigning sufficient reasons for such cancellation” (Government of Andhra Pradesh, 2010, p. 3, [online], the author’s emphasis). According to the Intellecrap White Paper “[s]uch discretionary provisions are often prone to abuse and applied haphazardly” (An Intellecrap White Paper, 2010, p. 4, [online]). In the article “The AP Ordinance on Microfinance – a solution with more problems,” N. Srinivasan points out that:

The requirements of the law are that a list of borrowers with details of each loan should be provided to the registering authority at the end of each month. With more than 23.5 million microfinance clients in the state, information handling is set to become a nightmare. The capacity of administrative machinery to handle registrations, monthly returns, complaints, no-objection certificates and penal proceedings may need to be increased manifold. ... Loading the authorities with a huge volume of work of a very different nature is bound to cause delays, frustration and generally chaotic conditions around these offices (Srinivasan, 2010, [online]).

As a response to a comment on the above quoted article N. Srinivasan argues:¹³⁴

¹³⁴ N. Srinivasan’s article is posted on Microfinance Focus, an online knowledge platform. As this is a platform open to discussions, others may comment on the articles that are posted.

What is galling is that suicides were given as the reason. In 2005, AP had high level of farmer's suicides (before the explosive growth of microfinance in AP) forcing PMO to design a special package (in AP, Karnataka, and Maharashtra states). The package is still running in the state in select districts. At that time the government was blamed with inaction against money lenders and banks were asked to write off loans, restructure debts and increase lending for agriculture. Now the blame has shifted to MFIs? (Srinivasan, 2010, [online]).

It can be read from this that the government, which controls the agents associated with the SBLP, both have been able to disclaim responsibility for their insufficient actions in regards to poor people being driven to suicides, and at the same time increased the SBLP's competitiveness relative to MFIs by blaming the MFIs for tragedies which might or might not derive from their actions.¹³⁵ As we saw on page 80, note 112, the SHGs covered under government's programmes had a comparatively bad repayment records, and it might have been a thorn in the government's side that the more expensive and not necessarily *socioeconomic* oriented MFIs now grows at a faster pace than the SBLP in terms of client acquisition.¹³⁶ Due to the scope of this thesis and the limited time available to me until it is due, I am in no position to explore and treat the Ordinance with the attention it deserves,¹³⁷ I have however chosen to extract and discuss a part of it; regulations regarding multiple lending/borrowing. I have done this because multiple lending was the topic in the former part of this chapter, and because I have data I think deserves attention from the second fieldwork that relates to tackling the farmer suicides (allegedly deriving from MFIs' practices which set of this ordinance).

In regards to multiple lending/borrowing the ordinance compels amongst others the following two stipulations:

No MFI shall grant loan to a member of SHG during the subsistence of two previous loans irrespective of the source of the previous two loans (Government of Andhra Pradesh, 2010, p. 5, [online]).

No member of an SHG shall be a member of more than one SHG, provided that where a member has, at the commencement of this Ordinance, become a member of more than one SHG, she shall have the

¹³⁵ "It should be noted that these suicides, while worrisome and tragic, are difficult to attribute to a specific cause without more evidence. Did the victim have a bad harvest and suffer economically? Was there a medical emergency in the family that was financially impossible to pay for? Was there a tragedy in the community? ... [O]nly an in-depth investigation (which mainstream MFIs have been among the first to call for) would prove or disprove the allegations of MFI coercion being responsible for these suicides" (An Intellecrap White Paper, 2010, p. 4-5, [online]).

¹³⁶ Though a slower growth rate might also connote that the SBLP have began to focus more 'in depth', undertaking a more inclusive growth, while the MFIs stick to growth in terms of easy client acquisition ('touch and go' growth).

¹³⁷ I recommend the Intellecrap White Paper: "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?" and N. Srinivasan's "The AP Ordinance on Microfinance – a solution with more problems" for a fuller understanding of the ordinance and its implications, and the AP Ordinance can be read in full at the Society for Elimination of Rural Poverty (SERP) webpage. SERP is an autonomous society of the Department of Rural Development, Government of Andhra Pradesh (Government of Andhra Pradesh, 2010, [online]).

option to retain the membership of one SHG and to terminate her membership in other SHGs and for that purpose, she shall issue a notice to such SHGs about her option to terminate her membership, settle and pay the amount payable to the MFIs which had lent monies to such SHGs, within a period of 3 months from the date of commencement of this Ordinance (Government of Andhra Pradesh, 2010, p. 4, [online]).

From what we have addressed hitherto in this thesis, I will suggest that a lot of clients all over the country are quite likely to have more than one loan. In AP, particularly, the propensity to borrow is documented to be high. “CMFs’ [Centre for Micro Finance’s] sample survey in AP brought out that 82% of families had loans from informal sources. The median number of loans taken by households was four. The chances are that three out four of these loans are from the informal sector“(Srinivasan, 2010, [online]). If the average number of loans taken by households in AP is four, and MFIs are prohibited from delivering a third loan to people regardless of whom they have borrowed the first two from (including all informal sources of credit) neither banks (due to the poor definition of MFIs as mentioned in note 133 on page 96), nor MFIs (defined in this thesis as the institutions other than banks that provides financial services), can continue to operate in AP. Second of all, how can the MFIs, in a cost efficient manner, make sure that potential clients have not taken more than one loan from an informal source? This is directly related to the problems of imperfect information that we documented to exclude poor people from formal financial services in chapter three. As formal banks find the cost of tracking the credit history of poor clients borrowing individually to be exceedingly high (partly the reason why banks excluded poor from their services), how than does the ordinance suggest that MFIs can find out whether or not a client has borrowed from a trader, a neighbour, a landowner or the like, while keeping interest rates (which must be high enough to cover the cost of lending out money) from going through the roof? If revealing external debt will result in clients having no access to formal credit, they naturally have little incentive to be truthful about their financial situation. Furthermore, as documented above, the reason why many approach multiple lenders is because one microloan does not cover their needs. Hence, how can restricting a client from taking a formal loan in order to reinforce her house before the monsoon season,¹³⁸ just because she has already approached a neighbour to borrow some money for food and her patron in need of farm input, be the best way to assist her?

Moreover, if a client should be a member of more than one SHG, the second stipulation gives that she might have to repay (large) debt in only three months. If the loan has

¹³⁸ Recall the discussion in chapter six with regards to how a microloan might help clients to tackle core components of poverty.

already been invested in something that does not generate an income right away, such as medical bills, fertilizer or for example a buffalo, I will suspect that the ordinance might drive clients to default, or possibly (further) into the arms of the informal lenders who do not care that the clients are not supposed to borrow from more than three sources. As mentioned prior, having to approach a moneylender out of desperation might result in the lender raising his interests further just because he can. Some clients might even have been trying to avoid lending from local moneylenders by participating in multiple SHGs; does the ordinance by its regulations really suggest that it is better for desperate women to approach informal lenders (even if the alternative is a ‘malicious agent’) than to be granted a formal loan to cover an unexpected medical bill, or to be allowed to repay the loan on the terms that was initially given for her repayment period (maybe even the reason why she chose to invest as she did)? If the suicides reported in AP was a result of people having problems with repaying their formal debt, this decision might not help the constrained situation of poor farmers, at least not until all the associated clients have been through the transformation of going from three, or maybe even five loans, to having just one.¹³⁹ During this transition phase, if feasible, I will strongly recommend making extensive counselling available to the people who (suddenly) find themselves in distress.¹⁴⁰ An admirable example of how this can be put into practice can be found in the following story told by Mr. Rajeev Deshpande:

Even if he have a loan of 25 000, only 25 000 loan, and he is unable to pay, the moneylender or the persons concerned or the cooperative, in some scrupulous limits, come and insult him. The attitudes of the farmers are that he does not want to bend in front of anybody, customs and traditions don’t permit them to tolerate insults. And that is unbearable, and he commits suicide. And behind him left is total distress, misery, and family is having that stigma, that in this family it has been committed suicide. On this burden, thousands of families are living at present, but if the society stands behind them, then definitely they will be normalised. (Monica: So are there some connections between farmer suicides and microloans?) I am just coming to that, six or seven thousand farmers have committed suicide in six districts of Maharashtra state. That is the most progressive state, so his distress we are addressing from Shree Hanuman Vyayam Prasarak Mandal Amravati in collaborating with bank of Maharashtra, I was director, and some local institutions. So this counselling centre we started. There we motivate them. There we transform technologies. There we ask the bankers to present their schemes. There we ask the collectors to present dues, the revenue site, address their problems, if there are specific problems, and there is a 24 hour helpline. This is directly addressing the problems of each and every farmer. We are creating the leadership, and up to now one lakh farmers have been counselled since last three years, and programme is continuing. Government of India, Prime Minister has issued one letter appreciating this programme and asking them to continue. ... One lakh farmers, not a single farmer has committed suicide. These farmers might not have heard of getting trained ever in their lives, but now this institution is standing very firmly on that and taking them along and intervenes them in the society.¹⁴¹

¹³⁹ Recall also that the reason why some approach multiple lenders is because the size of a microloan might be insufficient to cover their needs.

¹⁴⁰ This is something which I actually advocate in general in regards to people who have accumulated more debt than they manage to handle.

¹⁴¹ Expressed on the bus ride to visit with Aapni Sahakari Sewa Samiti Ltd. in Phagi, Jaipur (25.06.2010).

Despite my negative approach to the AP Ordinance, I still believe that the ordinance might be a blessing in disguise. The discussions currently running about its strengths and weaknesses might enable the policy makers at the national level to prepare the Act (which “has been holding flat for the last hundred years”¹⁴²) based on the lessons learned from this ordinance. The scenario is no longer the same as it was when I attended the group discussion on ‘Credit’ (the summary above). The government do now know “what kind of annual it is going to generate” and “we [do in fact] realise its shortcomings”¹⁴³ which should enable the GoI to sort out the flaws in the AP Ordinance and thereby do better the second time around.

¹⁴² Quoted above in the summary of the group discussion on ‘Credit’ I attended during the Annual Forum.

¹⁴³ Mr. Ratnesh’s statement quoted in the summary of the group discussion above.

Conclusion

The aim of this thesis has been to challenge the claimed outreach by considering the quality of it. As stated in Chapter one, the claimed outreach is such that most poor and even low-income households have access to formal financial services through the microfinance approaches.

This has prompted us to ask specific questions about its quality. Does the group lending approach correct for the market failures in the formal economy which excluded poor people prior to microfinance? Has competition in sector become too harsh? Is a person included in the formal economy if he has a bank account in his name? Is it the poor that are being reached through this tool for poverty alleviation? These questions do in my view contribute to determine the quality of the sector's outreach, and I therefore believe that answering them based on what we have addressed in this thesis will be a good way to assess the quality of the outreach, and to conclude the thesis. In the following we will address them one after the other, and thereafter, rounding off the thesis, we should be able to establish whether or not the outreach of the sector is overestimated.

9.1 Does the group lending approach correct for the market failures in the formal economy which excluded poor people prior to microfinance?

I will argue that it does. In chapter four we saw that the group lending approach have the property to tackle adverse selection and moral hazard that derives from imperfect information, because even though banks remains as ignorant as ever about who is safe and who is risky, they can take advantage of the fact that the group members themselves might have good information about fellow members and that the joint liability gives the members incentive to use their information to the bank's advantage. The banks transfer the job of screening potential borrowers, monitoring their efforts and enforcing contracts onto clients, and should a person default, the bank can still expect that the other group members will cover for the defaulter so as to ensure access to future services and to secure their pooled savings. Bringing the bank to the clients and actively seeking out the formerly unbanked further reduces the cost that is associated with poor people trying to access formal credit. Moreover, this means that microfinance have improved the formal sectors competitiveness relative to informal lenders. But as we have also noted, group lending has its downsides. It might have a discouraging/excluding effect on the poor who fear that they will not be able deposit the

weekly/monthly requirements, who are not strong or numerous enough to be in a group, who do not have the time nor can afford to prioritise group meetings, who fear that the responsibility of having to cover for other group members or who fear being vigorously monitored by them. Inefficiencies furthermore occur when good projects go unfinanced due to the default of a single member, when monitoring is too costly or time consuming, when clients experience imperfect information, and when groups do not chose to apply peer pressure on a defaulter because they understand the rational for defaulting. Providing loans through a group lending approach might even be regarded as a second rate service, but as we discussed, it appears to be the best option available at the time. This should not be viewed as an incentive not to try to improve the product, or to find better or more suitable methods; individual lending programmes, graduating client programmes or building better quality groups being some areas in which improvement is possible and in my view even desirable. However, as the new inefficiencies should be seen in comparison to the non-defaulting, but still formerly excluded, members' probability of accessing formal finance if microfinance had not been an option, I will argue that all the members accessing services through the microfinance providers outweigh the size of the new inefficiencies.

9.2 Has competition in the sector become too harsh?

Healthy competition tends to be beneficial for the demanders, but is the competition amongst the providers of microfinance healthy? In my view, the sector is characterised both by excessive competition, and by too little competition. One might argue that competition cannot be excessive and too low at the same time, but when restricted to certain areas of a whole, providers of microfinance have proven that it can. The providers compete for staff and clients, but as they often compete for the same staff and to reach the same clients, not staff in general or all clients, competition becomes both excessive and inadequate. That the processes through which groups are formed now is being cut back on implies that the most attractive clients appear to be those who are not too poor (as they assumingly will have less trouble meeting the weekly/monthly instalments), who require less coaching (maybe even those who others have already been trained) and who are the most willing. It might also imply that the most attractive staff consists of people who bring with them an already established client base. By focusing on the easily reached low risk villagers, staff members earn more incentives and banks are better able to reach their targets. That there is more competition over these clients than what is preferable we have documented by discussing the large extent of multiple

lending/borrowing that is going on in the sector, it can be seen in the mere fact that the AP Ordinance came into existence, and it is expressed in the testimonies of my informants who advocate for an Act. Not all areas are characterised by excessive competition though. In some areas microfinance is still an fairly unknown, or at least an inexperienced phenomenon to most, but the fact that we have seen how unhealthy competition is going on in areas that the microfinance penetration index shows still represent a gap on the microfinance map, for example Rajasthan and Uttarakhand (Srinivasan, 2009, p. 4), implies that too harsh competition do in fact coexist with too little competition in some areas.

9.3 Is a person included in the formal economy if he has a bank account in his name?

When practitioners of microfinance view financial inclusion as the ultimate goal, and not pay attention to the quality of inclusion, it opens for a gap that can be filled with ‘ghost accounts’. I am under the impression that the number clients expressed as being financially included, but who still lack access to formal financial services is worth taking notice of. A person cannot be said to benefit from microfinance when he does not know that a bank account has been opened in his name. As long as no transactions are made, and there is little or no money deposited into the account, I will, like a lot of the people I interacted with and interviewed during the fieldworks, argue that financial inclusion is not taking place. There has yet to be undertaken any comprehensive countrywide study that shows the extent of the financial exclusion of clients that per definition is included in the formal economy, and I am in no position to estimate the extent of the phenomenon. I will nonetheless make an educated guess and claim that it might be noteworthy, especially when we take into account the proxy borrowers who have lent out their names against a fee, who has been convinced by influential villagers to form groups because banks need to reach targets, or who have been pressured by superior villagers that need fifteen other people to make up a group in order to access the comparatively hassle free formal financial services providers of microfinance offer.

9.4 Is it the poor that are being reached through this tool for poverty alleviation?

As documented in chapter five, Hulme argues that the assumption of microfinance automatically being about working with the poor and poorest needs to be dropped unless the MFIs can provide clear evidence that it is the case (Hulme, 2007, p. 20), and Srinivasan have stated that “[t]he very poor with no resources may not be fitting clients of the financial system till the time their capacities are built” (Srinivasan, 2008, p. 3). As we discussed in chapter

four, ‘The size of microloans’, the time it take to build the poor’s capacities might be exceedingly long because microfinance is, as the name imply, an incremental approach. We saw in the same chapter how microfinance can enable a family to create a surplus that in time might contribute to create equality within the household,¹⁴⁴ and if a surplus covers the domestic needs, people furthermore avoid having to borrow in the informal sector out of necessity if that is something that they wish to avoid. These are all arguments for why providers of microfinance should focus on the poor, and seen in light of how the group lending approach lowers the risk of lending to the poor, I believe that it is mostly unfortunate practices and/or attitudes amongst some of the providers and policy makers that restrict the potential quality of the outreach. Based on what we have discussed in this thesis, I will suggest that excessive competition in the sector is the backbone from which the unfortunate practices and attitudes derive, though the strive for profit maximisation (in terms of ‘touch and go’ inclusion regardless of the degree of competition in an area) and incidents of corruption might naturally also weaken the quality of the outreach.

During the bus ride to visit Aapni Sahakari Sewa Samiti Ltd., a north eastern NGO worker and the man sitting next to him on the bus argued: “Because each state has different political party ruling the state and those parties still believe that it is their own state and they can do whatever they want. (Monica: So in such places MFIs are better options than the SBLP?) But MFIs will not go, because organisational activities will be very difficult for them to manage.”¹⁴⁵ If we see this statement in connection with the AP Ordinance discussed in chapter eight, it might be legit to argue that some political parties, or some state governments, directly restrict the outreach of the MFI approach, and thereby the quality of the outreach of the sector as a whole. This statement is be substantiated if the argument in chapter eight, that policy makers are displeased with being perceived as providing an inferior service despite the fact that MFIs tend to be more expensive and do not necessarily focus on the *socioeconomic* development of the poor, is accepted.

N. Srinivasan argues that “... actual coverage of poor is neither guaranteed nor clearly evident from several studies” (Srinivasan, 2009, p. 21). I am in no position to provide an

¹⁴⁴ A surplus can for example serve as insurance in case of an income earning family member falling sick, or cover medical bills of all the household members as there is no longer a need to prioritise nutrition for some over the health of all. Nor would there be any immediate need to discriminate in terms of nutrition in the household, which in turn might contribute to more family members having additional income earning days each year seeing that a healthy body is more resistant to diseases and that better nutrition is likely to increase productivity, and children might be allowed to attend school longer as the family becomes less depended on them to bring in extra cash.

¹⁴⁵ Extracted from a quote in chapter five, paragraph 5.8.

accurate number as to the poor being reached compared to the non-poor as no data is yet available as far as I know, but in this thesis we have established how the group based approach in itself might have an excluding effect on poor people, and on some subgroups of the poor, even though it was established to enhance financial inclusion of the very same people. We have also seen how competition among practitioners in some cases leads the providers to focus on easily reached areas and clients in their attempt to reach targets or to earn more incentives, and that a number of financially included people do not have access to, or benefit from, formal financial services.

9.5 Is microfinance living up to its promise?

When an organisation or an institution choose a ‘touch and go’ growth instead of going more ‘in depth’ in the area in which it operates, I will argue that microfinance cease to function as an effective tool through which all deserving financially excluded poor might experience economic development, and that the microfinance movement no longer lives up to its full potential in terms of creating socioeconomic development. Based on what has been discussed in this thesis, I am under the impression that this might be the case with microfinance in India. The incredible outreach of the sector might be somewhat overestimated. However, there is a big difference between not functioning perfectly and not working at all. Unfortunately the great things that are being realised from microfinance have not received the attention they deserve in this thesis as it set out to examine the flaws in the sector. Because credit is the service that most providers offer, I have held aside (more or less) discussions of initiatives like insurance, savings facilities, training centres, Banking Correspondents and Banking Facilitators, pension schemes, microleasing of objects that can generate an income, housing microfinance, education loans, sanitation schemes and so on, and I have not focused on the social empowerment of clients. All these aspects contribute to determine the success of the Indian microfinance movement, and many banks and MFIs actively work to improve the services they provide by taking advantage of, or by finance the development of, new technology which can enhance their outreach in a cost efficient manner (both to themselves and to potential clients).

However, credit continues to be the service which is most commonly provided in India, and a place to save is too often the only microfinance service complementing credit. But is it feasible to expect that giving poor persons a small loan automatically will lift them above the poverty line and make sure that they do not fall back down below it? The fact that

microcredit evolved into microfinance witness about that it is not. Yet, a lot of people (clients, providers, policymakers, researches and/or the media) expect that a microloan will turn a poor person's reality upside down, and when this is expected, they sometimes fail to see the smaller effects. Even though a microloan might not transfer poor into non-poor, it can contribute to lessen intra household discrimination in terms of nutrition, health care and education, or having access to a formal loan might allow a client not to borrow from an informal lender (if that is not desirable) in case of an emergency. A microloan might ensure some clients a steady income which will enable them to work their way out of poverty, or (perhaps more often) it might just be enough for the clients to complement the household's common basket of resources and permit them to spend money on goods that are not absolutely necessary for their survival. A microloan might furthermore be invested in a new roof, this will not lift a person out of poverty, but it might result in more income earning days a year if it keeps the client and her food storage dry (she will probably not fall ill as often). As this thesis has addressed the flaws in the sector in order to determine the quality of its outreach, to conclude that microfinance is actually working and that I believe it to be an appropriate tool through which socioeconomic development can take place, can seem inconsistent. However, the point of this thesis has been to raise awareness of the fact that there are flaws in the sector that restrict the much acknowledged Indian microfinance approaches, and their incredible outreach, from reaching their full potential. Further study is needed before it is possible to conclude to what extent the flaws documented here affects the overall quality of the sector. But my hope is that by raising awareness of their occurrence, both emerging developments and trends that have been addressed by many before me, this thesis can contribute to give the concerned people (practitioners, policy makers and clients) incentive to keep working towards an improved sector.

Appendix

1. A numerical example of how safer clients might get driven out of the formal credit market when banks are unable to discriminate between risky and safe borrowers.

Armendáriz da Aghion and Morduch, 2005, p. 41-43, provides an example that illustrates why safer clients get driven out of the market when banks are unable to discriminate against more risky customers. They consider an economy that is populated by individuals who seek to maximize profits, and where the banks are just trying to break even. The lender's net cost of capital is 40 cent per dollar lent, and the investors need to borrow to carry out their project because they have no wealth of their own, they are unable to put up collateral and they are risk neutral. The potential borrowers are further heterogeneous and are either inherently 'safe' or 'risky'. The bank does not know who is who, but it knows the fraction of safe types in the population.

A project requires \$100 of investment and takes one month to complete, but if a prospective borrower chooses not to borrow, he can earn \$45 a month working as a wage labourer. They make the assumption that safe borrowers succeed all of the time and earn gross revenues of \$2 for each dollar borrowed. Their expected revenue is thus \$200, of which the borrower has to repay the bank the value of the loan (\$100) plus the net cost of capital (\$40). In this case the safe borrowers will earn \$15 more from the investment than they would have obtained working as a wage labourers. The riskier borrowers invest in riskier projects, so when they succeed they gain more than the safe borrowers (\$222), but when their projects fail (which is 10 per cent of the time) they earn nothing. The expected gross revenue will thus be \$200 ($=0.90 \cdot 222$) for the risky borrowers as well.

The bank's concern will be to set the interest rate at a level that will ensure that the bank can cover its capital costs and the probability of defaults. If half of the population is safe and the other half is risky, the average probability of success is $0.5 \cdot 0.90$ (half of the population times its chance of succeeding) + $0.5 \cdot 1.00$ (the other half times its chance of succeeding) = 0.95 (an average 95 per cent chance of success). To calculate the interest rate the bank takes the cost covering sum of \$140 and divides it by the chance of a borrower to succeed with his project 95(%) and times the sum with 100 to find the percentage that a loan of \$100 will have to cost the borrower ($147.368\% \approx 147.4\%$). At the net interest rate of 47.4% both safe and risky clients will borrow as their net returns will be \$52.6 and \$67.4

respectively. The example reflects that borrowers neither repay interest or principal when they fail, and that the safe borrowers are cross-subsidising the risky.

This first scenario shows that a lender's poor information about the borrowers not necessarily creates inefficiency, but faced with more uncertainty it very well might. In the second scenario we keep everything the same, except making the risky borrowers more risky. Assume that they now only succeed 75 per cent of the time, but when they do well they will earn revenue of \$267. Again the risky borrowers can expect gross revenue of \$200 ($=0.75 \cdot \267) if they borrow, but the lender now face higher risk and need to adjust his interest rates to compensate. The probability of success in the population is now just $0.875 = 87.5\%$ ($= 0.5 \cdot 0.75 + 0.5 \cdot 1.00$). This implies that the bank will have to raise its interest rate to at least 60 per cent ($((140/87.5)100 = 160)$). At an interest rate at 60 per cent the risky individuals will still borrow because $\$267 - \$160 = \$80 > \45 , but the safe part of the population will turn to wage labour because $\$200 - \$160 = \$40 < \45 . Furthermore, once the safe clients leave the market, the cross-subsidisation cease, and the banks will be forced to set the interest rate even higher.

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